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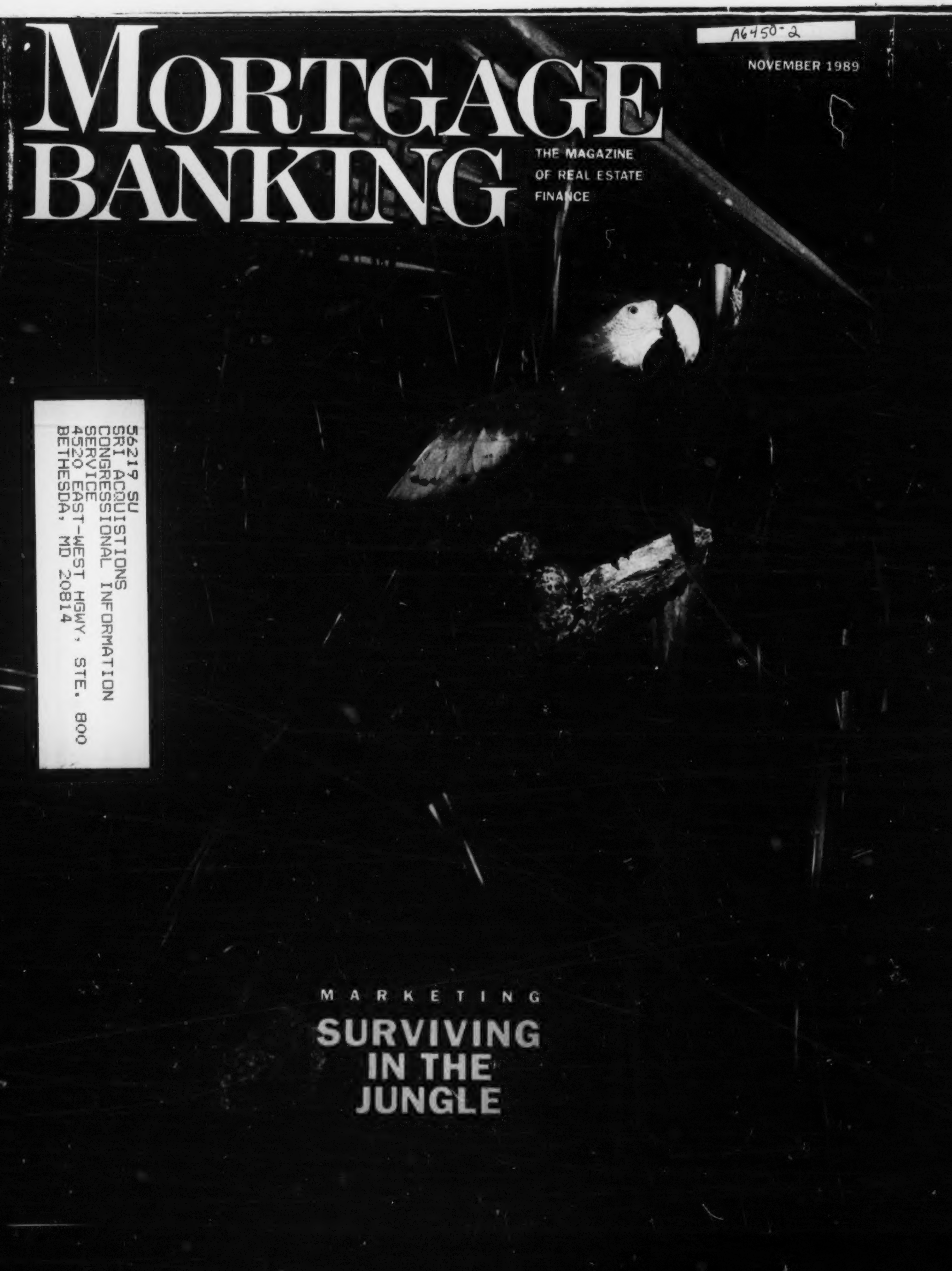
MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
FINANCE

NOVEMBER 1989



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MARKETING

SURVIVING IN THE JUNGLE

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NOVEMBER 1989 VOLUME 50 NUMBER 2

COVER: MARKETING —Surviving in the Jungle

It's a jungle out there. And survival will go only to the fittest. To be fit to compete in today's wild markets you need to set yourself apart—stand out. Plant your name in the customer's mind. Promote your shop, your products and your service to help your loan officers get out of this competitive jungle alive.

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COVER PHOTO BY GIPARO/THE IMAGE BANK

PORTFOLIO

Jungle Survival

Competing on price is quicksand. Competing on name is for Sears. Competing on the backs of star loan officers is very, very expensive. So, what's the average mortgage banker to do to survive in the steamy hot heart of today's competitive jungle?

Well, maybe, advertise? Some sophisticated marketing techniques might be in order.

Or, how about convincing your loan officers to sell not on price, but on the flexibility of the shelfload of products you already have? Why should your shop get beat out by thrift loan officers who are essentially trying to market one product—a negatively amortizing, monthly adjusting COFI ARM? If your sales staff insists on competing on the basis of start rates, there's little hope for fixed-rate products beating out ARMs or for secondary market–eligible ARMs beating out teaser ARMs. Train your staff not to go down that path.

Other jungle survival tips in this issue include a warning to avoid slavery to market share in regions dominated by thrifts practicing institutional cannibalism in the form of teaser-rate ARMs. A fixation on defending market share at all costs in such markets amounts to taking a poison dart in the heart of the balance sheet.

This issue also carries a report from Peat Marwick on how some of the very largest servicers did last year on the servicing cost front. In 1988, these servicers saw total servicing costs per loan climb 16 percent compared with 1987. Thirty-four percent of those costs were tied to bad loan losses. Core servicing costs—excluding bad loan losses—actually dropped slightly.

We hope these survival tips are more than simply informative, because as we all know, mortgage bankers want to succeed, not just survive.

Janet Reilley Hewitt
Editor

COMING IN DECEMBER

Byting the Bullet

Some mortgage firms are actually embracing the computer age. Countrywide and Margaretten are the two we choose to profile. Also, IBM's got its eye on the mortgage market.

MORTGAGE BANKING
THE MAGAZINE OF REAL ESTATE FINANCE

VOLUME 50 NUMBER 2

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Customer relationships opened up by mortgage lending sow the seeds for future business profits.

GROWING A PROFIT TREE

Throughout this decade, mortgage lending institutions, including the largest in the industry, lost money on loan origination.

But until now, few have been troubled by these losses. The institutions looked to servicing to generate enough profits to recoup the shortfall.

What has changed? It's the growing recognition that servicing will not generate the profits the industry seeks in the 1990s. In fact, according to Towers Perrin studies, the profit spread on mortgage servicing will steadily decline in the next decade, even for "mega-size" institutions (see Chart 1).

Mortgage lenders are already seeing industry profits and profit margins shrink. Many are now re-evaluating their commitment to the residential mortgage banking business. Indeed, news of major financial institutions exiting the business in the future should not come as a surprise.

But leaving is not the solution. Rather, for most institutions, the answer lies in redefining and repositioning the residential mortgage business.

Powerful market forces are restructuring the residential mortgage industry and, in so doing, are changing the requirements for success. In the emerging structure, consumer home mortgages will no longer be a viable stand-alone source of origination, servicing or secondary marketing profits.

Rather, mortgages will be originated as "gateway" products to broad-based financial services retailing. From the residential mortgage relationship base—or the "trunk" of the mortgage profit tree—will branch the sale of other retail products and services. Simply put, banks hoping to maximize profits from residential mortgages must begin concentrating on the total customer relationship, rather than focusing narrowly on a specific mortgage product business.

The key is to view financial services retailing from a long-term relationship perspective, rather than a single-product sale orientation. From this vantage point, a successful relationship looks much like the classic decision tree, with products such as mortgages (and checking accounts and insurance) serving as gateway or "root" products—the source of first-time customer contacts. These contacts can and should be developed into long-term, profitable multiservice/product relationships. Such relationships give retailers a valuable asset: an easily accessible, qualified market for all of their products and services.

Chart 2 shows how the residential mortgage profit tree can grow over time with diverse sales to home mortgage borrowers. As illustrated, a large number of financial services and products can be natural follow-ons to the residential mortgage.

> The key is to view financial services retailing from a long-term relationship perspective, rather than a single-product sale orientation.

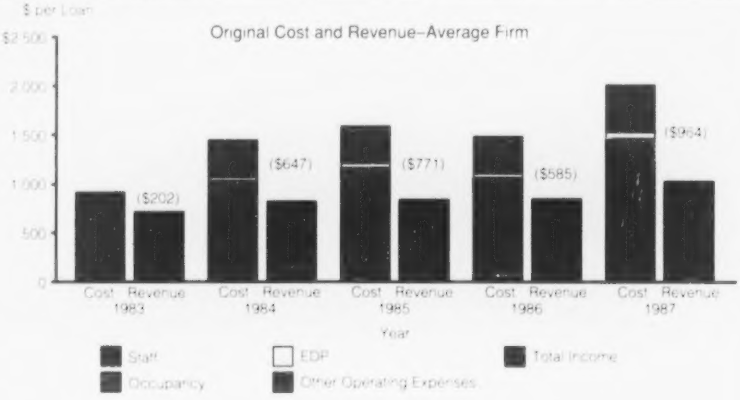
But the expanded mortgage relationship will not develop by itself. It must be nurtured by properly trained and motivated employees who understand both the needs of customers and the probable timetable for those needs. In other words, the relationship must be actively managed to reap the greatest profits. What does this involve?

David Partridge and Elizabeth Gall

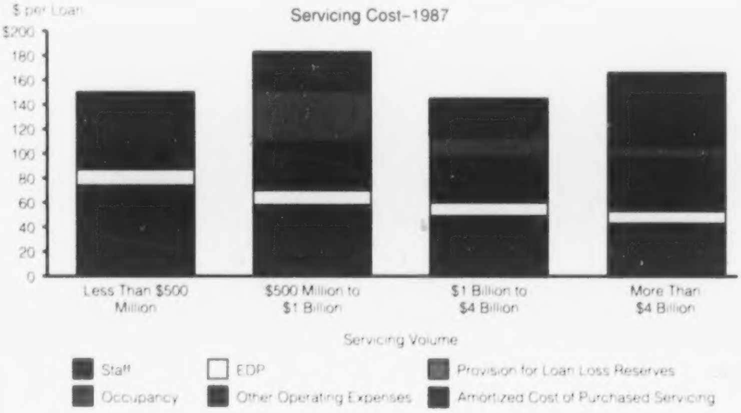
ILLUSTRATION BY JEANNE TURNER

CHART 1 Mortgage Industry Performance

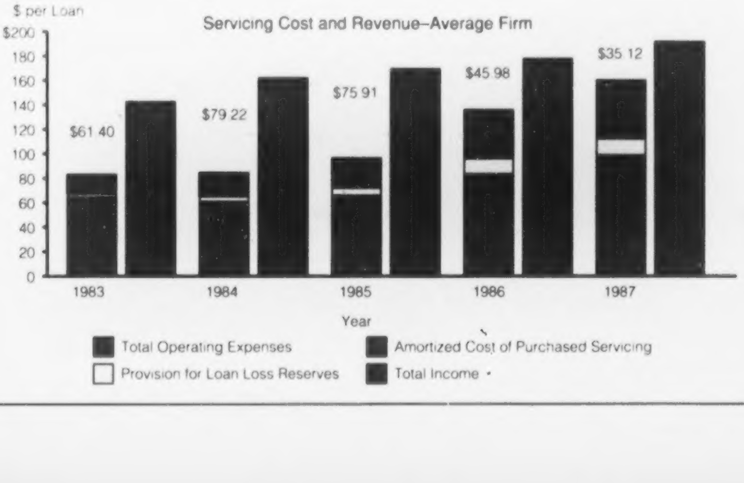
Increasing losses are evident in loan origination.



Operational economies in servicing appear to increase to a point and then diminish, overcome at higher volume by the amortized cost of purchased servicing.



Costs, especially for amortization of purchased servicing, have outpaced servicing revenue, squeezing net servicing income.



To grow the mortgage profit tree, lending institutions need to:

- Define the true potential value of retail customer relationships and the role of different products in this value stream.
- Devise marketing strategies that reflect the timing of consumer needs for differing products and services (e.g., at different stages in customers' lives; at different times of the year; or at different points in the mortgage relationship life cycle).
- Restructure origination and servicing departments to execute the new strategies.
- Develop performance management and reward systems that reinforce the chosen strategies.
- Find ways to increase mortgage origination productivity.

Value of the consumer relationship

There is no question that creating and sustaining these long-term relationships require time and effort by the retailer. Will it pay off? To answer that, the institution must value not only the initial mortgage sale but the entire profit tree. In other words, the profits from the offshoot sales must be factored in when assessing the value of these relationships. As management will discover, the tree has the potential to be extremely profitable.

As shown in Chart 3, a carefully orchestrated "relationship-selling" program can dramatically alter the economics of mortgage banking. Break-even time (recovering the losses incurred at origination) can be cut in half. The cumulative value of the relationship can be increased five times in only four years.

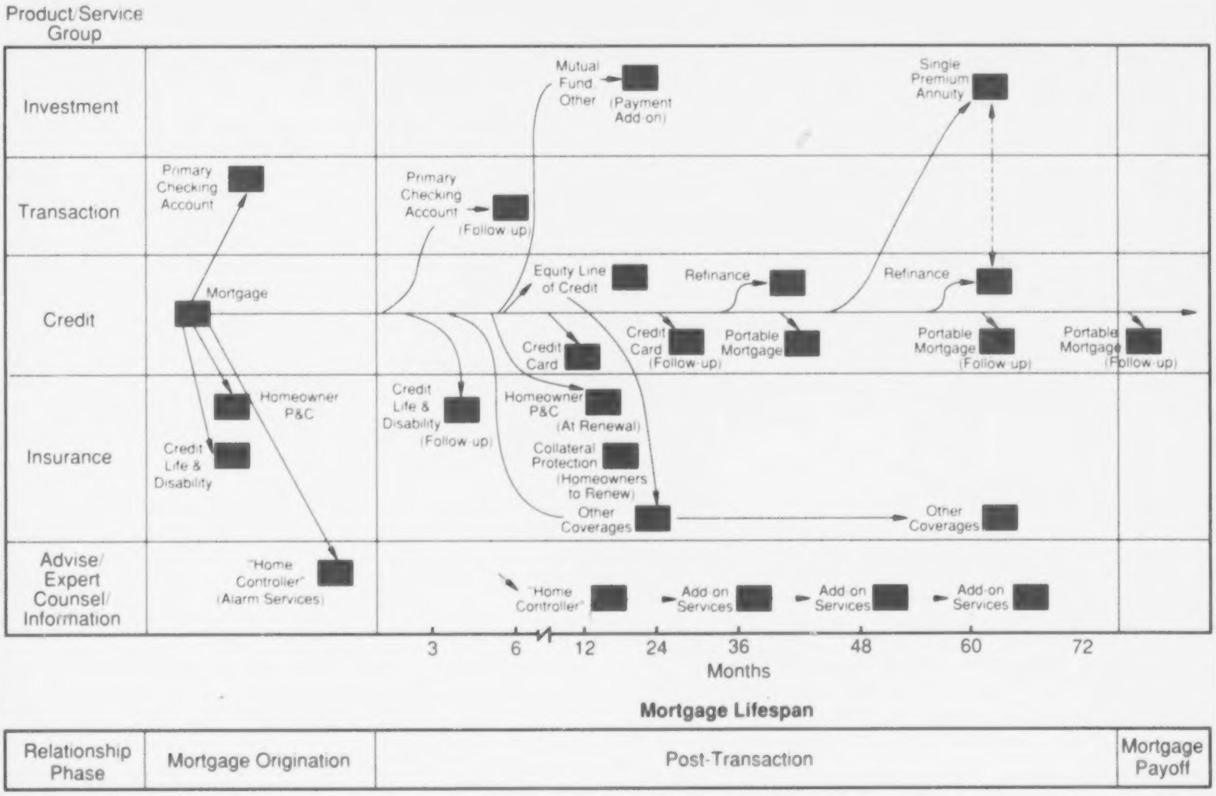
This valuable relationship will not happen by itself. Significant changes to organizational structure, staffing, compensation practices and marketing are required to realize the profit potential of the initial mortgage transaction.

Managing the relationship

Historically, mortgage retailers have not been successful in selling other products and services to their customers. Several factors help explain this:

- Lenders do not always understand the true economic potential of the expanded customer relationship

CHART 2 Natural Follow-ons to the Residential Mortgage


Product/Service Group
Investment
Transaction
Credit
Insurance
Advise/ Expert Counsel/ Information
Primary Checking Account
Mortgage
Homeowner P&C
Credit Life & Disability
"Home Controller" (Alarm Services)
Primary Checking Account (Follow-up)
Credit Life & Disability (Follow-up)
Mutual Fund Other (Payment Add-on)
Equity Line of Credit
Credit Card
Homeowner P&C (At Renewal)
Collateral Protection (Homeowners to Renew)
Other Coverages
"Home Controller"
Refinance
Credit Card (Follow-up)
Portable Mortgage
Add-on Services
Single Premium Annuity
Refinance
Portable Mortgage (Follow-up)
Other Coverages
Portable Mortgage (Follow-up)
3
6
12
24
36
48
60
72
Months
Mortgage Lifespan
Relationship Phase
Mortgage Origination
Post-Transaction
Mortgage Payoff

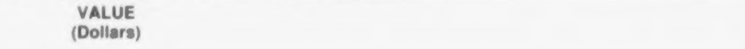
A customer relationship that begins with a mortgage has tremendous potential for further development.

and, therefore, are unwilling to make it a management priority.

- Current commission systems typically are based on one-time sales/originations that do not encourage relationship-building.
- Organizational structures, performance management systems and compensation practices in mortgage banking often create artificial barriers to cross-selling.
- Cross-selling programs often overlook the importance of timing in the sales process. Yet, there are clearly appropriate times in which to sell certain products and services (see Chart 2). Effective cross-selling must take this life cycle or "rhythm" into account.

Clearly, we believe that financial institutions need to rethink their marketing approach and the support systems and structures that reinforce their marketing strategies. First, and perhaps foremost, management needs to define and foster a new customer service ethic. This change could involve, for example, developing systems to speed mortgage processing

CHART 3 A Relationship-Selling Program



Astute competitors will try to create multiple-product relationships that are significantly more profitable than mortgage-only relationships.

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and closing. Rethinking the institution's marketing approach would also require rewarding mortgage originators for other products and services sold. In this context, incentives for originators might be based, at least in part, on the long-term value of the relationship. In addition, mortgage servicers' new cross-selling responsibilities would have to be recognized in incentive payouts.

Maximizing origination potential

As noted earlier, mortgage banking, as a business, is losing much of its economic attractiveness. Although loan origination will remain strong in the 1990s, it will not grow. Residential mortgage volume, which peaked at $454 billion in 1986, should remain in the $250-$350 billion range through the decade and then decline slightly (excluding inflationary effects on dollar volume). Thus, institutions that wish to make residential mortgages the root of their retail business strategy will have to expand market share in a static market. And as every marketer knows, such expansion is quite a difficult job.

Retailers who rely on offering a product mix carrying attractive rates and fees and who are geared at originating a good fixed/variable-rate balance, but who fail to support this mix with creative sales approaches, will fail to generate a satisfactory number of low-cost, sound mortgage originations.

To survive in the 1990s' competitive environment, lenders must look beyond the traditional source of mortgage referrals—real estate brokers—and find new ways of reaching customers. Possibilities to consider include:

- In-branch home buyer service centers
- Integrated home buyer/seller service packages
- Technology-based correspondent banking relationships
- Telemarketing to current customers
- Portable or "branded" mortgages

Such efforts, implemented cost effectively, should pay off handsomely—giving lenders an edge in a business that is a true gateway for harvesting profits from many branches of the residential mortgage profit tree. **MB**

David Partridge is a principal with Towers Perrin. Elizabeth Gall is a vice president of the same firm.

Positioning Your Servicing Operation for the 1990s

Very large servicers saw total servicing costs per loan climb 16 percent last year versus 1987. Bad loan losses deserve much of the credit.

Linda C. Simmons

Having survived the massive prepayments, refinancings and record loan volumes of 1986 and 1987, what challenges did the largest servicers withstand in 1988?

And what are these same servicers doing to position themselves for the mortgage servicing environment of the 1990s?

In June 1989, KPMG Peat Marwick completed its third annual Mortgage Servicing Performance Study (MSPS). Participants serviced an average of 100,000 loans or more in 1988. Questionnaire responses were examined and validated to ensure integrity and consistency. The information was then analyzed to develop (1) the cost of each functional area within servicing; and (2) the cost of the nonservicing attributes, such as interest expense and overhead allocation.

Representing industry leaders across the country, the participants gathered and submitted critical unit cost, productivity and operating data. Information was accumulated for 18 servicing functions and on key portfolio and compensation statistics.

Using Peat Marwick as data conduit, validator, analyst and facilitator, senior executives of participating firms met in June to review results and to profile enhancements to their operational efficiency and effectiveness. The study participants showed that they were able to use the results of the 1987 servicing performance study to improve their operations in 1988.

Overall cost results

Participants' core servicing costs ranged from $62 to $96 per loan, with an average of $84 per loan. The 1988 average core cost decreased slightly. The costs tied to each functional area within servicing comprise core costs. Core costs exclude collateral losses from bad loans, interest expense and allocated overhead. The distribution of core costs is depicted in Chart 1.

The total servicing cost per loan increased 16 percent compared with 1987 results. The increase was primarily due to a rise in bad loan losses. Total costs ranged from $100 to $260 per loan in 1988, with an average of $149. Thirty-four percent of total servicing costs—a category that included principal losses from loans sold with recourse, VA no-bids and non-reimbursable outside service expenses—was attributable to bad loans. Costs tied to bad loan losses were much higher than in 1987, when they made up 20 percent of servicing costs. (The relative distribution of total servicing costs is contained in Chart 2.)

Significant patterns

The bulk of the study's analytical focus centers on the 18 servicing functional areas. Some general and specific characteristics and patterns have been supported from the results gathered during the three years the study has been done:

- Overall, the study showed that the 1988 average core servicing costs decreased just slightly more than 1987's costs. Three participants were able to cut core costs from between 7 and 27 percent during the last year, while several experienced servicing core cost increases from between 7 and 12 percent. Two participants have been able to decrease costs each year of the study.
- For the third year in a row, there was no evidence that there are incremental economies of scale for the large servicers in the participant group. For this reason, a second study, directed at those who service between 30,000 and 80,000 loans, has been added for 1989.
- Once again, loans serviced per full-time equivalent (FTE) proved to be a general predictor of core servicing costs. For study participants, loans serviced per FTE ranged from 525 to 850. Several participants were able to improve considerably in this area compared with 1987 performance levels.
- There continued to be no apparent improvement in overall servicing costs or productivity from increased data-processing expenditures. Con-

sequently, data-processing costs require strict control and thoughtful justification. The exception to this was in investor services and cashiering where automation projects such as automated pool reporting, automated clearinghouse (ACH) products and computer-generated wire transfers helped increase productivity from 1987 levels.

- The number of loans serviced has remained relatively constant for most of the participant servicers. The group employed a wide variety of bulk purchase/origination combinations to maintain the number of loans serviced, with no apparent effect on core costs.

Dominant issues in 1988

The 1988 study produced some results that warrant highlighting:

- Collection, foreclosure, bankruptcy and REO costs ranged from $33 to $187 per loan, including bad loan losses, which accounted for 69 percent of the total servicing cost. Average losses from bad loans increased 75 percent compared with 1987 results.
- Fifty percent of the participants reported lower costs per loan for customer service during 1988, primarily because of streamlined operations and increased use of automation. Cross-training employees between various customer service functions appears to be a vital step in both increasing productivity and reducing the overall servicing cost.
- The purchased servicing amounts as a percentage of total principal balances in the servicing portfolios were surprisingly high for several participants. Particularly, this is so, when considering that these institutions also originate loans to obtain servicing rights. The future amortization expenses of purchased servicing could be as high as the core servicing costs per loan.
- A number of participants began or completed the consolidation of their servicing operations during the year. The cost benefits of these consolidations are expected in the coming year.
- Investor accounting costs can be dramatically affected by bank fees for custodial accounts. Most participants do not have adequate data to assess the cost of bank fees relative to the value of compensating balances.

> **Fifty percent of the participants reported lower costs per loan for customer service during 1988, primarily because of streamlined operations and increased use of automation.**

CHART 1 **Total Cost Distribution**

The collections and foreclosures and customer services department accounted for 44% of total servicing cost per loan, while loan losses contributed an additional 34% to the cost equation.

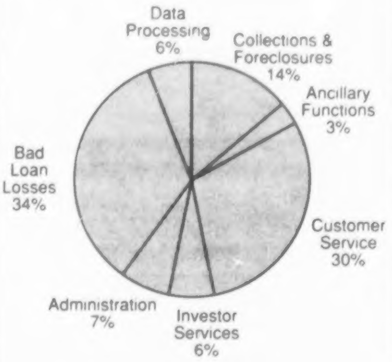
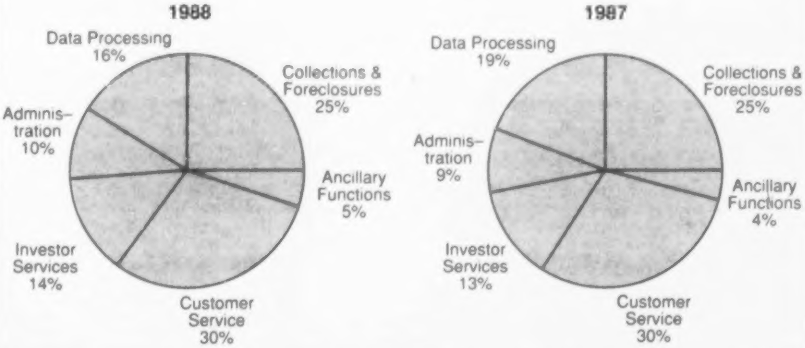


CHART 2 **Core Cost Distribution**

The core costs were largely influenced by the customer service and collections and foreclosures departments. Data processing was the only department that changed much between 1987 and 1988.



Emerging issues for the 1990s

One of the critical issues for any peer analysis is ensuring the compilation and analysis of comparable data. The 1988 study received a high participant vote of confidence that the data were indeed "normalized" and comparable. Hence, the study, with its established methods for determining costs, can now be used to explore how emerging issues in the mortgage banking industry will affect the cost of servicing.

To try to better understand how to maximize the value of the servicing function, the 1989 study will address the following specific issues:

- *Analyzing economies of scale for those servicing between 30,000 and 80,000 loans.* Results from the past three years support the theory that economies of scale still exist for the servicing function; however, the mythical cutoff point for realizing those economies has not been fully analyzed. We have introduced a second study, aimed at analyzing origination and servicing costs for those entities servicing between 30,000 and 80,000 loans, to address this and other theories regarding the servicing function.
- *Managing servicing portfolio risk.* Based on a variety of factors that are collected and analyzed in the study, we expect more detailed analyses of prepayment risk assessment and foreclosure risk assessment. Specifically, we will statistically examine

the geographical, fixed-versus-ARM and interest rate mix of participant portfolios to see if "prepayment prediction" factors can be determined. We will perform similar analyses on those factors inherent in assessing foreclosure risk.

- *Minimizing costs attributed to bad loans.* As highlighted above, collections, foreclosure department and bad loan losses together cost from $33 to $187 per loan. Effective quality control and processing to reduce these costs may be the critical factor in long-term profitability and survival. We will gather information on such quality-control practices in use and develop a cost comparison for the different approaches.
- *Assessing the impact of servicing transfers.* Results of the 1988 study were inconclusive as to the effect on costs and productivity of bulk purchases and sales. We will tailor the next questionnaire to highlight possible incremental costs attributable to servicing transfers: analysis, underwriting, systems setup and so forth.
- *Identifying variations in investor accounting costs.* Additional analyses will be performed on the variations in fees for custodial account and other attributes of investor accounting. A cost comparison for different approaches will be performed.
- *Assessing regulatory trends with respect to purchased and excess servicing.* Regulatory trends should be answered by planned response, not hasty reactions. We will perform analyses of current and anticipated regulatory trends on the participant servicing portfolios in an attempt to further the understanding of how to maximize the value of the servicing.

To date, the Mortgage Servicing Performance Study participants have used the results of these analyses for ongoing management review and updating of servicing operations and performance. In the future, participants will be able to use these analyses to position themselves strategically for the mortgage servicing environment of the 1990s. **MB**

Linda C. Simmons is a principal in KPMG Peat Marwick's Washington, D.C., office. Dr. Simmons is an active participant in the firm's National Mortgage Banking Practice. The 1989 MSPS will be conducted by the Washington, D.C., office.

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
	FHA	CONVENTIONAL[2]		Median Cost of Funds	1-Yr.	FRM		
1989	New Homes[1]	FRM	ARM	FSLIC Institutions	ARM	Conv.	ARMs	FRMs
JUN	10.32%	11.03%	10.03%	8.01%	8.73%	9.98%	9.03%	10.20%
JUL	9.85	10.66	9.84	8.07	8.24	9.72	8.74	9.88
AUG	9.78	10.33	9.57	NA	9.95	8.40	8.65	9.99
SEP	**NA**	**NA**	**NA**	**NA**	**8.54**	**10.06**	**8.71**	**10.13**

SELECTED SECURITIES

1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
JUN	9.53%	9.11%	7.93%	8.44%	8.37%	8.28%	9.65%
JUL	9.24	8.68	7.61	7.89	7.83	8.02	9.54
AUG	8.99	8.57	7.74	8.18	8.13	8.11	9.55
SEP	**9.02**	**8.70**	**7.74**	**8.22**	**8.26**	**8.19**	**9.55**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JUN	9.72%	9.76%	9.74%	144	148	146
JUL	9.44	9.47	9.48	142	145	146
AUG	9.49	9.53	9.53	138	142	142
SEP	**9.52**	**9.54**	**9.53**	**133**	**135**	**134**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1989	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
MAY	$1,626	$1,419	$193,681	$3,762	$5,233	$5,186	$5,141	$4,474	$4,452	$4,115
JUN	2,573	1,862	196,501	4,339	7,753	7,948	7,392	6,551	3,267	4,138
JUL	2,513	2,091	200,468	5,464	5,934	6,608	5,720	5,180	4,395	4,895
AUG	**2,842**	**2,724**	**203,923**	**5,081**	**7,863**	**5,709**	**7,283**	**6,360**	**6,161**	**5,463**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
8 MONTH AVG. 1989	2,036	1,584	---	4,676	6,214	6,530	5,806	4,522	4,280	4,384
1988	2,202	2,149	---	4,206	2,927	5,217	3,237	2,829	4,613	4,535
1987	1,999	1,558	---	5,781	7,163	7,740	7,903	7,726	11,243	9,435

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
MAY	1,308	1,019	289	1,347	970	377	176	244	513	375	179	245	528	395
JUN	1,406	1,027	379	1,308	940	368	168	242	552	444	177	234	506	391
JUL	1,424	1,086	338	1,281	979	302	195	267	532	430	160	232	478	411
AUG	**1,353**	**1,061**	**292**	**1,326**	**993**	**333**	**140**	**241**	**574**	**398**	**168**	**272**	**521**	**365**
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
8 MONTH AVG. (SAAR)														
1989	1,423	1,084	339	1,339	1,007	333	195	270	558	400	188	259	509	385
1988	1,473	1,134	338	1,427	1,063	363	259	274	562	384	252	263	529	383
1987	1,666	1,246	420	1,591	1,157	434	284	319	630	434	285	302	588	416

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1989	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
MAY	3,210	2,580	9.6	653	380	7.2
JUN	3,360	2,350	8.4	653	377	7.1
JUL	3,330	2,260	8.2	758	369	6.0
AUG	**3,440**	**2,310**	**8.0**	**755**	**364**	**6.0**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
8 MONTH AVG. (SAAR)						
1989	3,396	---	---	663	---	---
1988	3,502	---	---	673	---	---
1987	3,589	---	---	692	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1989	Total[6]	1-Unit	2+ Units	Nonresidential
MAY	$280.9	$98.6	$20.0	$79.1
JUN	280.0	97.3	19.9	80.1
JUL	278.6	97.0	20.0	78.8
AUG	**278.0**	**95.8**	**19.9**	**80.2**
1988 TOTAL	281.8	103.5	19.3	77.9
1987 TOTAL	283.0	100.7	22.4	78.2
8 MONTH AVG. (SAAR)				
1989	281.9	100.3	20.1	80.2
1988	278.9	102.6	19.3	77.8
1987	281.1	99.4	23.0	76.9

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 MAR	$29,946	$5,990	$14,841	$8,387	$51	$2,452	$155	$1,557	$434	$142	$11,052	$63	$1,630	$7,030	$2,086
APR	27,890	5,530	13,233	8,730	85	2,480	331	1,206	366	221	8,917	122	1,340	5,216	2,104
MAY	29,269	5,302	13,270	10,179	132	2,290	286	981	640	166	13,301	186	1,476	8,404	3,094
JUN	**29,495**	**5,477**	**12,372**	**11,120**	**157**	**2,268**	**159**	**971**	**698**	**134**	**13,208**	**95**	**1,246**	**8,773**	**2,976**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
6 MONTH AVG. 1989	32,414	5,347	12,809	8,856	93	2,506	271	1,251	558	177	11,069	104	1,438	7,300	2,093
1988	28,740	6,952	13,872	7,404	171	2,819	304	1,553	544	262	14,621	50	1,835	10,563	1,947
1987	42,066	11,635	18,281	11,572	309	4,279	204	1,823	843	246	12,430	335	1,992	8,177	1,834

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 MAY	149	91	15	43	93	$7,109	50	$3,167	15	$1,164	28	$2,778
JUN	157	96	15	46	107	8,155	60	3,774	14	1,072	33	3,309
JUL	153	92	14	47	94	7,411	48	3,060	13	985	33	3,366
AUG	**177**	**110**	**18**	**49**	**105**	**8,208**	**55**	**3,511**	**14**	**1,102**	**36**	**3,595**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
8 MONTH AVG. 1989	143	85	16	42	100	7,559	56	3,488	15	1,160	29	2,911
1988	154	85	17	52	111	8,020	58	3,430	17	1,273	36	3,317
1987	229	124	40	65	214	14,827	126	7,851	44	3,156	44	3,820

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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MORTGAGE BANKING

COMPUTERS

Changing the Landscape

************** 5-DIGIT 20814
SRI ACQUISTIONS 37
CONGRESSIONAL INFCRMATION 315
SERVICE
4520 EAST-WEST HGWY, STE. 500
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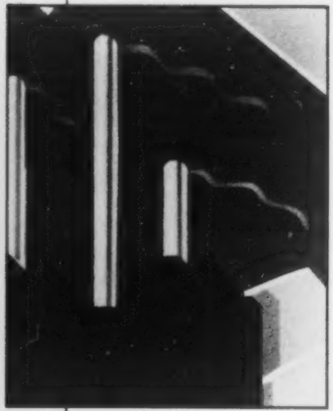

Working on a computer for the first time can be tough sledding. But when you are up to your ankles in paper—as many mortgage companies are—computers represent a glimmer of hope that there is a better way. So, if your processors are shoveling out from under too much paper, this issue should offer some good cheer. And, best wishes for a computer-literate new year.

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PORTFOLIO

Computer Terminology

Computers have their winning ways about them. Just when you think you've had it with trying to learn computers—reading overly detailed, tedious descriptions of how to do something simple like turn the machine on—someone comes along and shows you a way to simplify your working life tenfold. That's it. You're hooked.

If ever there was an industry designed for computers, it's mortgage lending. It's amazing that automation has taken so long to get a grip on this business of forms and more forms. But then again, maybe it is not so amazing if you consider that IBM just discovered the mortgage banking industry two short years ago. Where was it when you needed it? Well, there's no worrying about the reasons now. IBM is here, with its corporate sights set on you. This issue carries a feature on the new marketing team IBM has fashioned to help sell you on doing business better with its ideas, with the software vendors the company has teamed up with and with its technology.

Then there's something called imaging—technology that stores document images in digital form so computers can pull up the stored data instantly. Servicing departments may never be the same. Countrywide is blazing the trail using this technology, and the story is an interesting one. It makes microfiche look positively archaic.

Computers also can help lenders spot suspicious details in loan originations, such as two loans written for the same individual who said each property—in different locations—would be owner occupied. Hard to do—yes, virtually impossible. But Travelers has developed a sophisticated set of databases that permit crosschecking facts to sniff out the bad loans early on.

Finally, a computer and an art director came together for the first time to produce this month's cover. Kudos to Sarah Hollander. Happy Holidays to all our readers, and brace yourselves for another challenging year. We will revisit computers in February to see if you learned anything in the interim.

Janet Reilley Hewitt
Editor

COMING IN JANUARY

More Nice Weather

The economic outlook is the subject of our first issue of the next decade. The forecast is for a further cooling of growth and a breakup of the dark storm clouds of inflation that hovered on the horizon this year. In the words of Lyle Gramley: "The problems of economic overheating . . . are now over." The question now is, How chilly will it get?

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Banks' portfolios are looking more and more like thrifts'. What are the odds that the thrift industry's problems will be repeated?

BANKS HOW HEALTHY ARE THEY?

William C. Ferguson

On the surface, the financial health of the commercial banking industry looks robust. Industry earnings for 1988 rebounded sharply from the dismal performance of 1987. Earnings for the first and second quarters of 1989 remain strong, and earnings for 1989 as a whole will probably surpass 1988.

However, in spite of high reported earnings for the banking industry overall, the picture is not as rosy as it seems. In my view, it would be a mistake to take the savings and loan debacle too lightly. Economic, competitive, technological and legal changes will continue to buffet the entire financial system, and depository institutions in particular.

The pace of change seems to be accelerating, and we—financial analysts, regulators, managers and lawmakers—may not be able to predict, or even comprehend, and respond to these changes.

Now with FIRREA behind us, I expect we will hear a new series of debates concerning the wisdom and necessity of reforming the structure of financial institutions and the deposit insurance system. In response to the growing number of financial institution failures, many proposals have been offered to radically restructure the financial institutions system and the deposit insurance system. Although these proposals may provide a foundation for theoretical discussion, most are impractical in the real world.

It is my view that substantial and fundamental improvements in the safety and soundness of the banking system and its deposit insurance fund can be achieved with modest changes.

This article focuses on three arenas:

- Factors influencing the health of the banking industry.
- The current state of the industry.
- Prospective condition of the commercial banking industry and the Bank Insurance Fund (BIF).

This article includes certain financial information pertaining to the commercial banking industry. For purposes of this article, the information omits data pertaining to savings banks insured by BIF.

All financial information presented was derived using computer tapes generated by BIF and purchased from the U.S. Department of Commerce. Such tapes contain final financial information through 1987 and preliminary financial information for the year ended Dec. 31, 1988, and the three months ended March 31, 1989 (the latest data released by BIF). Since amended reports may be filed by commercial banks after preliminary tapes are released by BIF, the financial information included in this article may differ somewhat from information prepared by BIF for other forums. However, such differences are not expected to be significant enough to affect the validity of the analysis or conclusions reached in this article.

Banking during the next decade

A variety of forces will change the structure of the banking industry during the next decade. These factors include the following:

- *Continued deregulation of entry.* Interstate banking will accelerate as legal barriers continue to disappear. As a result of FIRREA, cross-industry acquisitions will be numerous and will become commonplace.
- *Competition and continued cost pressures.* Deregulation will result in unrestricted competition in the financial services industry. As a result, both the asset and liability sides of the balance sheet will be under pressure, and interest margins will tend to become narrower. Institutions will be forced to continue searching for more efficient ways to deliver financial services and, in the process, achieve greater economies

of scale. In addition to competition among commercial banks, competition will also come from nondepository institutions such as money market funds, Fannie Mae, Freddie Mac and the investment banking community.

- *Regional economic and demographic trends.* Financial institutions in distressed or declining areas will remain in jeopardy. High-quality credits will be scarce in these areas, and many institutions will find it difficult to survive on the spread that can be obtained from investment income. The Southwest economic crisis has demonstrated the pitfalls that await those financial institutions attempting to survive in depressed regional economies.
- *Overcapacity and consolidation.* We are an "overbanked" nation served by too many depository institutions. With increasing competition and reduced interest margins, the overcapacity will probably lead to a rapid wave of consolidations. Even today, we have a smaller number of commercial bank charters than at any time since the Great Depression. In addition to pressures from competitive forces, mergers and acquisitions will be driven by increased capital requirements and perceptions as to economies of scale. It is not unreasonable to expect that the number of "banking" offices of all depository institutions will be reduced considerably by the end of this century.
- *Restructuring of bank balance sheets.* As commercial and industrial loan demand has shifted from commercial banks to the investment banking community, concentration in real estate lending by commercial banks has grown steadily during the last several years. As experience in the thrift industry has demonstrated, real estate lending provides the potential for incurring substantial interest rate risk and loan losses. The balance sheets of many commercial banks today look similar to those of thrifts of yesteryear.

In summary, absent any return to regulation of deposit costs, the commercial banking industry will continue to experience a large number of voluntary mergers, involuntary mergers and liquidations as the nature of the industry continues to change.

> The balance sheets of many commercial banks today look similar to those of thrifts of yesteryear.

The primary public policy issue is how to adapt the regulatory, supervisory and deposit insurance system so that the safety and soundness of the financial system, the deposit insurance funds and the payments mechanism is ensured as we enter the rapidly changing decade of the 1990s.

In short, what is needed to preserve the stability of the system is more rigorous enforcement of capital standards coupled with more timely and accurate financial data to provide additional protection to BIF.

However, a more rapid regulatory response system, including an early intervention program, will also be needed, not only to protect BIF but also to ensure the stability of the banking system.

Nevertheless, even with improved regulatory policies and a favorable external economic environment, competition and technology will create a high level of financial institution mergers, and perhaps failures, during the next decade.

Current state of the industry

Ferguson & Co. collected data that show some financial highlights for the commercial banking industry for 1986, 1987 and 1988 and for the three months that ended March 31, 1989, segregated by asset size of the institutions. The industry is broken down by number of banks in each of the size categories show below in Table 1.

TABLE 1

Size	Number
Total Assets Greater Than $10 Billion	42
Total Assets $1–$10 Billion	328
Total Assets $100 Million to $1 Billion	2,445
Total Assets Less Than $100 Million	10,185
Total	13,000

The financial data indicate that the industry in general is well capitalized throughout all size categories. However, I expect the upcoming risk-based capital standards to require many banks with total assets of more than $1 billion to raise additional capital.

Additional data gathered show financial highlights for the commercial banking industry by region for 1986, 1987 and 1988 and for the three months ended March 31, 1989. While the banks in each region are, in general, well capitalized, there are significant differences in return on average assets by region. These differences are summarized in the following table:

TABLE 2

	Return on Assets			
	1986	1987	1988	3/31 1989
All Banks	0.66	0.12	0.76	0.95
Southwest Banks	0.01	(0.17)	(0.26)	0.19
Midwest Banks	0.79	0.73	0.91	1.22
Southeast Banks	1.07	0.96	1.00	1.00
Northeast Banks	0.79	(0.15)	0.98	0.88
Central Banks	0.91	0.43	1.08	1.11
West Banks	0.39	0.02	0.90	1.18

Translating these figures into dollars, banks as a whole enjoyed profits of $22.76 billion in 1988, while banks in the Southwest had losses of $609 million.

Chart 1 presents detailed financial information for banks in each state as of March 31, 1989. This chart shows a geographic pattern of troubled institutions that those familiar with the current state of the thrift industry will recognize.

Looking more closely at the numbers on a state-by-state basis, Texas, Arizona, Louisiana and Oklahoma (in that order) were the states with the worst performance for the first quarter of 1989.

There is some evidence that the worst is yet to come in the Southwest. For instance, nonaccrual loans increased from 3.88 percent of total loans at the end of 1988 to 4.88 percent at the end of the first quarter of 1989.

Similarly, owned real estate/total assets increased from 1.44 percent at the end of 1988 to 1.78 percent at the end of the first quarter of 1989.

Chart 1

All Commercial Banks

Selected Financial Information at March 31, 1989 (Dollars in Thousands)

		Balance Sheet									Income Statement						
		Total Assets	Equity Capital	Equity Capital/ Avg. Assets	Primary Capital	Primary Capital/ Avg. Assets	Loan Loss Reserves/ Total Loans	Nonaccrual Loans/ Total Loans	Net Chg-Offs/ Avg. Loans	ORE/ Total Assets	Net Income (Loss)	Return on Average Assets	Net Int. Income/ Avg. Assets	Prov. for Ln & Ls Loss/ Avg. Assets	Nonint. Income/ Avg. Assets	Securities Gains(Ls)/ Avg. Assets	Nonint. Expense/ Avg. Assets
AL Totals,	221 Institutions	$ 33,563,403	$ 2,747,503	8.25%	$ 2,953,534	8.87%	1.23%	0.66%	0.24%	0.18%	$ 91,518	1.10%	3.61%	0.25%	1.11%	0.03%	3.09%
AK Totals,	8 Institutions	3,711,213	403,585	11.13	427,046	11.78	2.23	5.31	0.04	0.53	9,888	1.09	4.15	0.45	1.34	0.01	3.74
AZ Totals,	46 Institutions	28,074,026	1,778,668	6.38	2,076,258	7.45	2.07	5.44	1.53	1.16	12,331	0.18	4.04	1.22	1.36	0.01	4.05
AR Totals,	256 Institutions	18,504,541	1,580,997	8.58	1,744,817	9.47	1.69	1.75	0.48	0.60	48,149	1.04	3.83	0.35	1.06	0.00	3.24
CA Totals,	473 Institutions	306,047,255	17,345,792	5.81	24,737,856	8.29	3.02	2.68	0.90	0.47	942,572	1.26	4.59	0.53	1.98	(0.00)	4.22
CO Totals,	446 Institutions	24,761,337	1,844,937	7.51	2,186,108	8.90	2.41	3.46	1.33	1.54	35,727	0.58	4.20	0.63	1.81	0.00	4.56
CT Totals,	70 Institutions	39,382,882	2,586,127	6.67	2,820,795	7.27	1.07	1.17	0.85	0.18	69,519	0.72	3.66	0.48	1.13	(0.03)	3.26
DE Totals,	45 Institutions	59,138,955	5,338,414	9.18	6,376,408	10.96	2.65	0.32	2.56	0.01	213,765	1.47	5.74	2.06	2.88	0.00	4.25
DC Totals,	25 Institutions	16,668,643	1,069,755	5.87	1,349,427	7.40	1.69	1.02	0.16	0.14	38,865	0.85	3.41	0.19	1.10	(0.00)	3.09
FL Totals,	415 Institutions	122,276,222	7,895,536	6.59	8,968,669	7.49	1.43	1.34	0.58	0.79	219,099	0.73	3.94	0.57	1.34	0.00	3.68
GA Totals,	382 Institutions	60,297,591	4,586,181	7.78	5,038,126	8.55	1.38	0.70	0.48	0.22	175,183	1.19	4.34	0.40	1.41	(0.01)	3.82
HI Totals,	22 Institutions	14,175,192	930,541	6.87	1,068,482	7.88	1.61	0.44	0.04	0.03	43,368	1.28	4.41	0.29	1.20	0.09	3.46
ID Totals,	22 Institutions	7,339,880	522,524	7.05	611,574	8.25	1.83	0.95	0.40	0.27	21,203	1.14	4.30	0.28	1.13	(0.04)	3.43
IL Totals,	1,140 Institutions	186,074,124	11,937,921	6.44	15,246,818	8.23	2.92	2.15	0.73	0.14	505,987	1.09	3.09	0.21	1.16	0.02	2.80
IN Totals,	331 Institutions	52,842,584	4,008,374	7.69	4,405,091	8.45	1.35	0.95	0.46	0.14	135,335	1.04	3.73	0.35	0.93	(0.03)	2.95
IA Totals,	583 Institutions	30,494,182	2,709,497	8.91	2,971,953	9.78	1.86	0.89	0.23	0.43	88,785	1.17	3.75	0.19	0.86	(0.01)	2.84
KS Totals,	577 Institutions	25,191,842	2,072,260	8.23	2,322,176	9.22	1.80	1.51	0.42	0.69	67,686	1.08	3.94	0.41	0.84	(0.01)	2.92
KY Totals,	332 Institutions	36,858,804	2,942,464	8.04	3,242,544	8.86	1.41	1.10	0.37	0.19	99,484	1.09	3.59	0.35	0.93	(0.02)	2.80
LA Totals,	247 Institutions	35,624,761	2,539,521	7.19	2,959,007	8.38	2.49	3.76	1.30	1.46	31,674	0.36	3.65	0.87	1.10	(0.02)	3.45
ME Totals,	19 Institutions	7,740,674	526,566	6.87	583,042	7.61	1.11	0.76	0.34	0.09	20,505	1.07	4.44	0.31	1.05	(0.03)	3.74
MD Totals,	102 Institutions	48,653,376	3,464,500	7.26	4,072,209	8.54	1.44	0.55	0.38	0.15	127,725	1.07	4.07	0.34	1.11	0.01	3.35
MA Totals,	104 Institutions	109,405,568	6,575,066	6.05	7,787,404	7.17	1.69	2.12	0.39	0.32	202,011	0.74	3.05	0.37	1.62	0.11	3.28
MI Totals,	284 Institutions	86,323,836	5,564,249	6.57	6,500,230	7.67	1.49	0.85	0.64	0.14	225,236	1.06	3.80	0.36	1.08	(0.02)	3.17
MN Totals,	651 Institutions	49,803,294	3,438,884	6.91	4,268,905	8.58	2.10	1.85	0.57	0.28	123,901	1.00	3.59	0.40	1.34	(0.04)	3.16
MS Totals,	123 Institutions	19,560,329	1,527,946	7.96	1,646,236	8.58	1.56	0.74	0.46	0.36	52,025	1.08	3.62	0.28	1.08	(0.01)	3.16
MO Totals,	966 Institutions	53,808,438	4,172,172	7.74	4,713,477	8.74	1.69	1.36	0.46	0.37	144,436	1.07	3.68	0.37	1.11	(0.00)	3.02
MT Totals,	170 Institutions	6,785,894	525,060	7.65	609,689	8.89	2.31	2.73	0.34	0.60	19,544	1.14	4.26	0.27	1.07	(0.02)	3.48
NE Totals,	409 Institutions	17,359,090	1,467,558	8.50	1,645,295	9.53	2.03	1.29	0.39	0.33	55,744	1.29	4.37	0.32	1.69	(0.03)	3.94
NV Totals,	17 Institutions	13,334,515	859,726	6.38	1,085,234	8.06	2.24	0.76	1.48	0.26	86,768	2.58	7.37	1.38	1.56	(0.00)	4.32
NH Totals,	52 Institutions	9,314,243	630,904	6.84	718,689	7.79	1.18	0.87	0.82	0.13	29,319	1.27	5.83	0.97	0.60	0.01	3.56
NJ Totals,	126 Institutions	85,000,129	5,650,905	6.66	6,569,451	7.74	1.43	1.35	0.28	0.05	250,837	1.18	4.12	0.30	0.94	0.02	3.13
NM Totals,	93 Institutions	10,248,428	767,841	7.54	858,314	8.43	1.62	2.72	0.50	0.95	25,810	1.01	4.23	0.44	1.05	(0.00)	3.51
NY Totals,	203 Institutions	690,288,302	37,725,198	5.53	55,715,657	8.17	3.80	5.27	0.52	0.10	1,267,958	0.76	2.66	0.29	1.95	0.02	3.06
NC Totals,	71 Institutions	69,877,207	4,292,107	6.36	4,759,575	7.05	1.19	0.50	0.17	0.13	182,936	1.08	3.30	0.22	1.36	0.00	3.02
ND Totals,	160 Institutions	6,819,148	570,925	8.37	651,759	9.56	2.27	1.55	0.36	0.39	16,026	0.94	3.92	0.41	0.72	(0.00)	2.96
OH Totals,	299 Institutions	102,136,128	7,168,300	7.18	8,039,476	8.06	1.48	1.16	0.72	0.07	302,939	1.21	4.20	0.58	1.28	(0.04)	3.35
OK Totals	458 Institutions	25,842,263	1,972,879	7.65	2,283,899	8.86	2.77	4.36	1.42	1.88	26,202	0.41	3.74	0.60	1.25	(0.01)	3.75
OR Totals,	52 Institutions	20,089,794	1,359,418	7.12	1,525,831	7.99	1.32	1.23	0.84	0.23	56,498	1.18	4.55	0.57	1.33	(0.00)	3.59
PA Totals,	296 Institutions	159,621,237	9,700,015	6.16	12,183,410	7.74	2.12	2.11	0.57	0.16	407,556	1.04	3.28	0.30	1.25	(0.00)	2.91
RI Totals,	12 Institutions	14,391,944	937,309	6.70	1,205,917	8.63	1.90	1.50	0.79	0.51	44,589	1.28	3.89	0.54	2.21	0.01	3.68
SC Totals,	80 Institutions	21,240,256	1,448,534	7.03	1,595,892	7.75	1.26	0.48	0.34	0.09	53,744	1.04	4.01	0.34	1.06	(0.01)	3.37
SD Totals,	132 Institutions	19,124,078	1,521,247	7.52	1,707,593	8.44	2.46	1.25	4.18	0.12	125,372	2.48	6.41	3.37	6.04	(0.05)	5.76
TN Totals,	267 Institutions	44,188,258	3,268,697	7.61	3,713,018	8.65	1.48	1.10	0.50	0.28	104,167	0.97	3.84	0.41	1.24	0.00	3.41
TX Totals,	1,436 Institutions	168,298,765	8,313,560	5.36	10,566,090	6.81	2.67	5.71	2.23	2.01	(17,148)	(0.04)	2.88	0.89	1.46	(0.01)	3.41
UT Totals,	57 Institutions	11,095,756	813,376	7.38	954,140	8.66	2.12	1.90	1.21	0.91	18,123	0.66	4.46	0.65	1.17	(0.01)	3.90
VT Totals,	26 Institutions	5,471,492	399,360	7.40	433,878	8.04	0.92	0.83	0.22	0.08	16,837	1.25	4.72	0.34	1.04	(0.00)	3.67
VA Totals,	186 Institutions	60,936,436	4,103,446	6.81	4,686,152	7.78	1.07	0.49	0.43	0.09	171,976	1.14	3.97	0.39	1.14	0.01	3.26
WA Totals,	88 Institutions	33,429,334	2,268,879	6.91	2,631,026	8.01	1.54	1.54	0.37	0.50	103,352	1.26	4.78	0.52	1.83	0.00	4.42
WV Totals,	197 Institutions	16,292,686	1,432,024	8.86	1,526,983	9.45	1.19	0.87	0.45	0.33	45,182	1.12	3.97	0.25	0.57	(0.00)	2.83
WI Totals,	517 Institutions	41,820,571	3,339,726	8.03	3,696,078	8.90	1.31	1.20	0.25	0.21	123,191	1.19	3.98	0.26	1.17	(0.01)	3.29
WY Totals,	88 Institutions	4,081,087	357,235	8.63	395,251	9.55	2.33	2.80	0.87	0.96	10,344	1.00	4.18	0.20	0.90	(0.00)	3.54
AQ Totals,	1 Institution	32,864	3,725	11.91	3,962	12.73	1.68	0.63	0.70	0.00	118	1.51	5.38	0.13	0.97	0.00	4.28
GU Totals,	1 Institution	359,590	30,124	8.48	31,577	8.89	1.26	0.03	0.89	0.02	2,072	2.33	5.85	0.45	1.18	0.00	4.19
PR Totals,	15 Institutions	14,239,333	925,416	6.65	1,027,943	7.39	1.39	2.04	0.70	0.11	27,679	0.80	3.93	0.52	0.73	0.00	3.17
TQ Totals,	1 Institution	8,962	650	7.11	668	7.20	0.98	0.10	0.89	0.00	(38)	(1.66)	4.38	0.00	0.53	0.00	6.67
Gr. Totals,	13,000 Institutions	$3,150,080,643	$201,864,224	6.52%	$251,902,649	8.14%	2.36%	2.56%	0.74%	0.38%	$7,323,674	0.95%	3.62%	0.46%	1.53%	0.01%	3.36%

Risk to the deposit insurance fund

Looking ahead, at the end of the first quarter of 1989, there were 443 banks with total assets of almost $35 billion still operating that had net operating losses in 1987, 1988 and the first quarter of 1989. This listing excludes the subsidiary banks of two Texas holding companies whose losses were reserved by the FDIC in 1988, Texas American Bancshares and National Bancshares Corp.

The equity capital ratio of this group of banks has dropped from 7.34 percent at the end of 1986 to 4.36 percent at the end of the first quarter of 1989.

Correspondingly, the losses for this group have accelerated from $117 million in 1986 to more than $837 million in 1988. They had losses in the first quarter of 1989 of approximately $181 million.

The ratio of nonaccrual loans to total loans for this group has increased from 4.68 percent at the end of 1986 to 7.19 percent at the end of the first quarter of 1989.

Again, regional economic factors strongly influence the profitability of these banks. Of these 443 banks, 181 were located in Texas, 49 were based in Colorado, 31 were in Florida, 27 were located in Oklahoma and 21 in Louisiana.

If the present earnings trends for these banks continue, this group will run out of capital between late-1990 and mid-1991. Assuming a gross resolution cost to BIF of 25 percent of total assets, total costs to BIF could be in the range of $8 billion to $9 billion for this group.

Clearly many of these institutions are candidates for early intervention by the FDIC.

The outlook

The prospective condition of the banking industry and BIF is strongly influenced by three factors: LDC debt, regional economic trends and real estate lending.

LDC debt. The valuation of LDC debt is an issue that affects a few primarily money center banks. However, the valuation of such debt has a significant potential impact on the balance sheets of these institutions. Because of the special role and visibility of these banks, this issue has an impact on the stability of the entire banking and financial system.

Clearly, defaults—either formal or informal—pose substantial financial risks to a handful of money center banks that are not likely to be permitted to fail.

Although some progress has been made toward appropriately reserving against these assets, money center banks probably have a long way to go in developing adequate reserves for their LDC portfolios.

I understand the argument in favor of "quiet diplomacy" on this matter among the regulators, the money center banks and other interested parties. However, it might make sense for the congressional banking committees to set specific bench marks for improved reserves for these assets during the next several years and to direct the General Accounting Office to monitor performance of the banking agencies and banks in meeting those stiffer and more realistic reserve requirements.

Regional economic trends. The economic collapse of the Southwest economy has posed a severe test for

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the present depository insurance and regulatory systems. Moreover, other regional economies can be expected to suffer similar, if not so severe, economic downturns. The regulators now have the powers, resources and political will to contain and minimize the financial damage to the banking system inherent in any normal regional economic cycle.

Real estate lending. In rough numbers, commercial bank real estate loans outstanding have been growing at a rate of $100 billion per year, in spite of strong competition from the thrift and mortgage banking industries. At the end of the first quarter of 1989, there were 7,832 banks with assets of $1.18 trillion that had more than 40 percent of their loan portfolios in real estate loans.

In short, many banks resemble thrift institutions if you just look at their loan portfolios—with a substantial portion of real estate loans in residential mortgages. Clearly, this trend will increase the exposure of banks to interest rate risk. After all, it was interest rate risk exposure in the late seventies and early eighties that destroyed the capital base of the savings and loan industry.

In a post-FIRREA era, there will be greater opportunities for banks to increase real estate lending because of a substantial reduction in the number of savings institutions and the capital-driven regulatory constraints on the growth of many remaining thrifts.

Moreover, if commercial real estate lending is a risky activity for a thrift, is it not equally risky for a commercial bank? Should the FIRREA constraints imposed on such lending activity by thrifts be extended to commercial banks?

It seems unreasonable to limit by law thrifts' loan portfolio exposure without at least evaluating the exposure of commercial banks to the same risks. Moreover, risk-based capital rules will encourage banks to make long-term residential mortgage loans, exposing them to the potential double jeopardy of asset specialization and increased interest rate risk.

There is a real question in my mind as to the wisdom of setting a low minimum core capital requirement for banks unless an interest rate risk component is simultaneously established as an integral part of a bank's risk-based capital requirements.

Cautious optimism

With the new powers bank regulators gained under FIRREA, and the regulatory reforms suggested, a modified version of our present deposit insurance and bank regulatory system should meet foreseeable needs.

The existing depository, supervisory and regulatory system can be modified and modernized to work effectively at least through the first half of the 1990s and achieve our public policy goals of a relatively stable, safe and sound financial system without undue additional financial risks to the insurance fund and the Treasury.

Looking beyond the mid-1990s, it is too early to tell what kind of a financial system will evolve. More radical reforms in our regulatory system may be appropriate as a new set of private market institutions develops. **MB**

William C. Ferguson is chairman and CEO of Ferguson & Co., a financial institution consulting firm that has offices in Irving, Texas, and Washington, D.C.

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VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1989	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
JUL	9.85%	10.66%	9.84%	8.07%	8.24%	9.72%	8.74%	9.88%
AUG	9.78	10.30	9.56	8.08	9.95	8.40	8.65	9.99
SEP	9.95	10.34	9.62	NA	8.54	10.06	8.71	10.13
OCT	**NA**	**NA**	**NA**	**NA**	**9.81**	**8.30**	**8.62**	**9.95**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
JUL	9.24%	8.68%	7.61%	7.89%	7.83%	8.02%	9.54%
AUG	8.99	8.57	7.74	8.18	8.13	8.11	9.55
SEP	9.02	8.70	7.74	8.22	8.26	8.19	9.55
OCT	**8.84**	**8.53**	**7.62**	**7.99**	**8.02**	**8.01**	**9.39**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JUL	9.44%	9.47%	9.48%	142	145	146
AUG	9.49	9.53	9.53	138	142	142
SEP	9.52	9.54	9.53	133	135	134
OCT	**9.40**	**9.42**	**9.42**	**139**	**141**	**141**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1989	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
JUN	$2,573	$1,862	$196,501	$4,339	$7,753	$7,948	$7,392	$6,551	$3,267	$4,138
JUL	2,513	2,091	200,468	5,464	5,934	6,608	5,720	5,180	4,395	4,895
AUG	2,842	2,724	203,923	5,081	7,852	5,705	7,283	8,650	6,161	5,463
SEP	**2,328**	**2,223**	---	**6,883**	**7,979**	**7,708**	**7,889**	**8,050**	**5,181**	**5,740**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
9 MONTH AVG. 1989	2,157	1,655	---	4,922	6,409	6,660	6,037	5,645	4,380	4,534
1988	2,117	2,033	---	4,363	3,086	5,346	3,343	2,929	4,765	4,663
1987	1,982	1,579	---	5,593	6,774	7,204	7,502	7,329	11,854	9,090

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUN	1,406	1,027	379	1,308	940	368	168	242	552	444	177	234	506	391
JUL	1,420	1,083	337	1,281	979	302	189	274	531	426	160	232	478	411
AUG	1,332	1,045	287	1,328	1,004	324	145	236	565	386	174	263	517	374
SEP	**1,263**	**1,022**	**241**	**1,296**	**999**	**297**	**170**	**243**	**477**	**373**	**168**	**246**	**499**	**383**
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	106
9 MONTH AVG. (SAAR)														
1989	1,403	1,075	328	1,335	1,007	328	192	267	548	395	186	256	507	385
1988	1,470	1,132	338	1,424	1,063	361	254	267	561	389	245	262	531	386
1987	1,668	1,248	420	1,581	1,147	433	280	317	637	432	281	300	586	414

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1989	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
JUN	3,360	2,350	8.4	647	377	7.2
JUL	3,330	2,260	8.2	742	370	6.1
AUG	3,480	2,330	8.0	719	367	6.3
SEP	**3,630**	**2,250**	**7.4**	**618**	**367**	**7.6**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
9 MONTH AVG. (SAAR)						
1989	3,427	---	---	651	---	---
1988	3,517	---	---	672	---	---
1987	3,571	---	---	687	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1989	Total[5]	1–Unit	2+ Units	Nonresidential
JUN	$280.0	$97.3	$19.9	$80.1
JUL	274.5	97.0	20.0	78.8
AUG	274.3	95.4	19.6	81.4
SEP	**270.8**	**94.4**	**19.2**	**79.2**
1988 TOTAL	281.8	103.5	19.3	77.9
1987 TOTAL	283.0	100.7	22.4	78.2
9 MONTH AVG. (SAAR)				
1989	279.5	99.4	19.9	80.2
1988	279.2	102.7	19.4	77.7
1987	281.4	99.6	22.7	77.2

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 APR	$27,890	$5,530	$13,233	$8,730	$85	$2,480	$331	$1,206	$366	$221	$8,917	$122	$1,340	$5,216	$2,104
MAY	29,269	5,302	13,270	10,179	132	2,290	286	981	640	166	13,301	186	1,476	8,404	3,094
JUN	29,495	5,477	12,327	11,120	157	2,268	159	971	698	134	13,208	95	1,246	8,773	2,976
JUL	**27,273**	**5,522**	**10,819**	**10,390**	**200**	**1,733**	**296**	**680**	**407**	**222**	**15,597**	**135**	**835**	**12,533**	**1,967**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
7 MONTH AVG. 1989	27,466	5,372	12,518	9,075	108	2,396	274	1,169	536	183	11,716	109	1,353	8,048	2,075
1988	29,669	7,057	14,367	7,706	202	2,934	380	1,559	565	277	14,567	61	1,846	10,536	1,908
1987	42,001	11,088	18,575	11,747	318	4,221	209	1,859	836	266	12,902	307	2,048	8,575	1,885

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 JUN	157	96	15	46	107	$8,155	60	$3,774	14	$1,072	33	$3,309
JUL	153	92	14	47	94	7,411	48	3,060	13	985	33	3,366
AUG	177	110	18	49	105	8,208	55	3,511	14	1,102	35	3,595
SEP	**147**	**85**	**16**	**46**	**116**	**8,981**	**68**	**4,326**	**13**	**1,033**	**35**	**3,622**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
9 MONTH AVG. 1989	143	85	16	42	101	7,717	57	3,581	15	1,146	29	2,990
1988	153	84	17	52	111	8,187	58	3,544	17	1,298	36	3,345
1987	220	118	39	63	209	14,561	123	7,665	42	3,082	44	3,814

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

AC450-2

JANUARY 1990

MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
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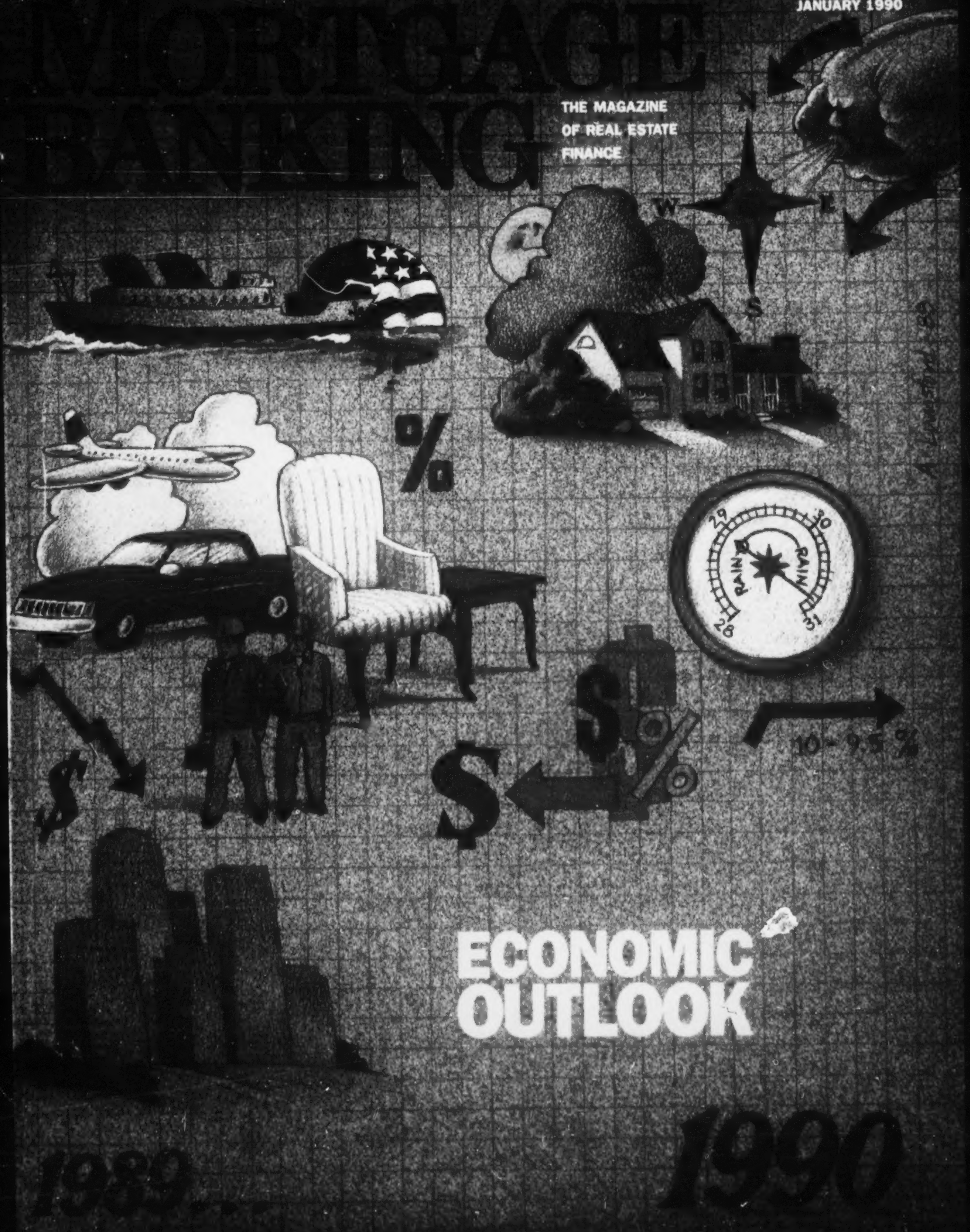
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1990

ECONOMIC OUTLOOK

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JANUARY 1990 VOLUME 50 NUMBER 4

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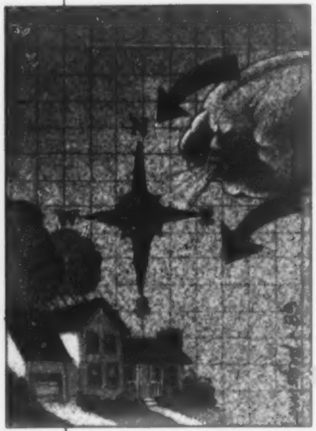

The old North wind has been blowing some serious cold air on the Northeast and real estate markets there have caught a chill. The stock market got a shiver up its spine when it realized that property prices in the sunshine state and elsewhere may have ended their relentless climb upward. But the outlook is not all bad—you just have to know how to dress for it. In this issue we explore the forecast for housing in 1990.

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PORTFOLIO

Real Estate Shivers

It was hard not to notice and cringe a little when the Dow took a major 42-point nosedive in December on some bad news about declining real estate values. But most people in the real estate lending business knew that a softening of property values had been in the works for some time before the Dow focused on it. Yet, somehow the stock market has its own way of burning something into the public's consciousness.

But one-day plunges in the stock market, or moves by regional banks to beef up reserves for non-performing property loans do not accurately portray the outlook for housing in the many different markets around the country. The fact is that even the outlook for the U.S. economy overall obscures local market conditions that can vary as much as night and day.

Keeping that in mind this month's issue offers an article on the regional housing outlook alongside our annual comprehensive economic forecast for interest rates, GNP, inflation and the other key factors that drive the fixed-income securities markets crazy.

One of the big questions on the horizon now of course is are we hovering on the brink of a recession. And then, leave it up to the economists to break down that rather pragmatic question into a more arcane discussion of whether we are headed for a "growth recession" or entering an actual recession-recession. We asked mortgage bankers and housing economists to offer their observations on what a housing recession might mean for the mortgage lending industry and whether we might be in the midst of one already in some parts of the country.

The overall package we put together appears to imply that basic economic conditions for 1990 will favor fixed-rate mortgage lenders—with rates for such mortgages drifting lower into single digits during the year. The thrifts have also been directed to back off steep discounting of ARMS by their regulators and that will be a boon to mortgage lenders trying to compete head on with such aggressive competition. The Federal Reserve under Alan Greenspan also appears a unique ally to mortgage lenders in 1990 because of its delicate mission to produce a soft landing for the weakening U.S. economy. All things considered, it's hard to think of a nicer ally to have in your corner. Happy New Year.

Janet Reilley Hewitt
Editor

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VOLUME 50 NUMBER 4

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THE OUTLOOK FOR 1990

The signs look good for 1990. Mortgage bankers should win a bigger share of the market as fixed-rates dip into single digits.

Lyle E. Gramley and Richard W. Peach

The outlook for the economy and the housing industry in 1990 looks reasonably favorable. Although economic growth will be slower than in 1989, a recession is not on the horizon.

The inflation problem, which forced the Federal Reserve to tighten its monetary policies during 1988 and early 1989, appears to be improving a bit. Consequently, interest rates are likely to come down somewhat further. This, of course, is good news for the housing industry and for mortgage bankers.

The economy's growth has been slowing. Nonfarm gross national product (GNP) rose $5\frac{1}{2}$ percent in 1987; growth began to slow in 1988, and during the first three quarters of 1989, the annualized growth rate was just $2\frac{1}{2}$ percent. This moderation in the rate of economic expansion is most welcome.

Increases in the labor force and in productivity were both rather moderate at year-end 1989. Those two factors limit the potential long-run growth of our economy to about $2\frac{1}{2}$ percent a year. Growth of GNP at much more than a $2\frac{1}{2}$ percent rate eventually leads to accelerating inflation and higher interest rates, as was the case in 1988 and early 1989.

It takes a while for inflationary pressures to cool once they begin to build. Early in 1987, prices of consumer goods and services—other than food and energy—began to move up faster in response to the economy's strong growth. By the end of 1988, year-over-year increases in these prices were running around $4\frac{3}{4}$ percent, a full percentage point higher than at the start of 1987.

Since early 1989, the rate of consumer price inflation has moderated to between $4\frac{1}{4}$ and $4\frac{1}{2}$ percent. Although this is no great accomplishment, any easing of inflation so soon after an economic slowdown begins is somewhat surprising; it attests to the strength of competitive winds that are currently blowing through the economy.

Reasons for slower growth

The slower growth of the U.S. economy, together with modest improvement on the inflation front, has taken some of the heat out of the financial markets. During 1988, the threat of worsening inflation forced the Federal Reserve to tighten monetary policy, and the interest rate on federal funds rose more than three percentage points between March 1988 and March 1989. Since then, the Fed has eased its policies in several small steps, bringing the funds rate down to a little below 9 percent as of mid-November. The 30-year Treasury bond yield had come down to below 8 percent, and effective rates on fixed-rate mortgages had fallen close to 10 percent also by that time.

The economy's slower growth stems from developments in a number of major sectors of aggregate demand. Export growth has moderated considerably from the robust pace of late 1987 and the first half of 1988. Our exports are still increasing in response to the economic boom under way in Western Europe and Japan. But the U.S. share of world markets is no longer rising rapidly, as it was a year ago.

In the housing industry, activity has declined considerably during the past several years; total housing starts are about one-fourth below early-1986 levels. Nonfinancial factors—such as high vacancy rates in apartment buildings, tax reform and weakness in the basic demand for housing because of demographic factors—are the main reasons for declining housing starts. But, of course, it didn't help to have mortgage interest rates rising as they did in late 1988 and early 1989.

As housing activity has declined, so has demand for household durable goods, such as furniture and appliances. Consumer demand for other categories of durable goods also moderated, during the course of the economic expansion, because backlogs of demand have been filled and consumer debt levels have risen relative to income.

Finally, defense spending has been declining since mid-1987, after an extremely strong rise during the early 1980s. Restraints on federal government spending are taking hold, at least in this area of the budget.

A resurgence of activity in any of these sectors would be quite surprising. So, the economy's overall growth should remain fairly tranquil. We believe, as a result, that the problems

ILLUSTRATION BY ANNE LUNSFORD

of economic overheating that were worrisome in 1987 and 1988 are now over.

Indeed, we see signs of cyclical weakness developing that will probably lead economic growth to slow further in 1990. Business cycles tend to be concentrated in the durable goods industries. New orders for durables began to rise strongly in early 1987, signaling the strengthening of business activity then under way. Although aircraft orders are still high and rising, orders for durable goods, excluding transportation equipment, have remained essentially unchanged since late 1988.

A more decisive indication of developing weakness in the economy is the trend visible by late 1989 in backlogs of unfilled orders for durable goods. After rising strongly from early 1987 to early 1989, these backlogs have begun to decline and are now below the level of a year earlier.

Employment in manufacturing has been declining since last spring. About 150,000 jobs have been lost in the durable goods industries. Job increases in the manufacturing sector spurred growth in consumer incomes and spending power from early 1987 until recently. We believe this recent weakness in manufacturing employment portends slower gains in consumer buying in 1990.

These combined elements of weakness do not imply, however, that the economy will topple into recession—although we can't rule out that possibility. They do suggest a period of very modest growth ahead. We expect economic growth to subside in the first quarter of 1990 and then to pick up a bit over the remainder of the year. If real GNP grows at an average annual rate of $1\frac{1}{2}$ to 2 percent during 1990, as we are forecasting, the rate would be below the economy's $2\frac{1}{2}$ percent growth potential. Consequently, unemployment would increase gradually—from about $5\frac{1}{4}$ percent in late 1989 to a range of $5\frac{1}{4}$ to $5\frac{3}{4}$ percent by late 1990. Increased slack in labor and product markets should help moderate inflation a bit further, but with labor still in short supply, we would be lucky to see inflation come down below 4 percent.

The Federal Reserve already eased its monetary policies in response to the weaker economic numbers that emerged by late 1989 and the stock market crash on October 13. We believe that further steps toward ease will occur during the first half of 1990. The dollar's present strength should help persuade the Fed that easier policies are appropriate.

Consequently, the chances are good that interest rates will be declining during the first half of 1990. By midyear, the 30-year Treasury bond is expected to be at the lower end of a range from $7\frac{1}{2}$ to 8 percent. Short-term interest rates are also likely to come down, probably somewhat more than long-term rates.

Job increases in the manufacturing sector spurred growth in consumer incomes and spending power from early 1987 until recently. We believe this recent weakness in manufacturing employment portends slower gains in consumer buying in 1990.

These are rather modest declines in interest rates that we are forecasting. Larger declines could occur if the economy's growth weakens more than we expect early in the year. Any decline in interest rates, however, will be helpful to the housing and mortgage banking industries. Thus, after weathering a few very difficult years, mortgage bankers can look forward to a better year in 1990.

Interest rates peaked lower

With the economy cooling off, and the threat of higher inflation receding, the peak of mortgage interest rates in 1989 occurred at somewhat lower levels than we expected. Effective rates on fixed-rate mortgages (FRMs) peaked at about $11\frac{1}{2}$ percent in late March and then declined to about 10 percent by early August. FRM rates backed up about 50 basis points by the end of August as credit market expectations of an imminent recession and massive easing by the Fed proved unfounded. But effective rates have since declined to around 10 percent, and prospects are quite good for further reductions in long-term interest rates in the months ahead. We expect FRM rates to decline to $9\frac{1}{4}$ to $9\frac{1}{2}$ percent by mid-1990.

While effective rates on FRMs were about 150 basis points below their previous peak by November of last year, effective rates on ARMs had declined only about 80 basis points by then, narrowing the spread between FRMs and ARMs from nearly 200 basis points in mid-1988 to about 120 basis points. Our analysis suggests that the spread will narrow further, perhaps to an average of just 100 basis points during 1990.

This narrowing of the FRM-ARM spread appears to be caused primarily by a diminution of "suicide" pricing of ARMs by thrift institutions. The movement away from this aggressive pricing posture has changed dramatically the spread between the effective rate on ARMs and the rate on one-year Treasury notes—the most common ARM index. This spread has rocketed from a negative 30 basis points as recently as March to about 140 basis points in the last few months of 1989.

Predictably, the decline of FRM rates and the narrowing of the FRM-ARM spread have reduced consumer preference for ARMs. From a range of 55 to 60 percent during the first quarter of 1989, the ARM share of conventional loans closed declined to 25 percent in September. Thus, the ARM share has returned to the levels that prevailed during the first half of 1987. A modest further decline in the ARM share may occur, particularly if FRM rates decline as expected. However, since these figures were first collected in mid-1982, the ARM share has never dipped below 20 percent. Therefore, an average of 25 percent seems a reasonable forecast for 1990.

Sales of both new and existing homes have responded positively to the decline in mortgage interest rates. From a trough of 3.2 million (annualized) in May 1989, sales of existing single-family homes rose about 13 percent to 3.63 million units in September 1989. This recovery has been particularly strong in the Midwest and South. Resale markets in the Northeast and

CHART 1

MBA Outlook for Housing and Real Estate Financing

	Actual			Forecast[1]	
	1986	**1987**	**1988**	**1989**	**1990**
Mortgage interest rates[2]					
FRM	10.6%	10.0%	10.4%	10.3%	9.4%
ARM	9.5%	8.5%	8.5%	8.9%	8.4%
Sales of Existing Homes[3]					
Single-Family	3,565	3,526	3,594	3,440	3,600
Percent Change	10.9%	-1.1%	1.9%	-4.3%	4.7%
Condo/Coop	332	361	357	370	380
Percent Change	19.0%	8.7%	-1.1%	3.6%	2.7%
Housing Starts[4]:					
Total (in thousands)	1,805	1,621	1,488	1,400	1,470
Percent Change	5.7%	-10.2%	-8.2%	-5.9%	5.0%
1-4 Family (in thousands)	1,263	1,212	1,140	1,080	1,130
Percent Change	8.3%	-4.0%	-5.9%	-5.3%	4.6%
Multifamily (in thousands)	542	409	348	320	340
Percent Change	-5.9%	-24.5%	-14.9%	-8.0%	6.3%
New Single-Family Homes Sales[4]	748	671	676	670	680
Percent Change	8.7%	-10.3%	0.7%	-0.1%	1.5%
Median Home Prices					
New[4]	$92,000	$104,500	$112,500	$120,000	127,200
Percent Change	9.1%	13.6%	7.7%	6.7%	6.0%
Existing[3]	$80,300	$85,600	$89,300	$92,600	$96,500
Percent Change	6.4%	6.6%	4.3%	3.7%	4.2%
Total 1-4 Family Mortgage Loan Originations (billions)[5]	$455.1	$449.5	$374.5	$390	$410
Percent Change	87.2%	-1.2%	-16.7%	4.1%	5.1%
Refinancings as a Percent of Total[6]	39%	35%	19%	22%	20%
ARMs as a Percent of Conventional Loans Closed	31%	43%	60%	40%	25%
Mortgage Bankers Market Share[5]					
$s (billions)	$131.6	$110.1	$85.3	$98	$110
Percent	28.9%	24.5%	22.8%	25%	27%

[1] Forecasts by MBA's Economics Department.
[2] Effective rates on conventional loans closed. Source of historical data: FHLBB.
[3] Source of historical data: National Association of Realtors.
[4] Source of historical data: U.S. Department of Commerce.
[5] Source of historical data: HUD.
[6] Historical series and forecast estimated by MBA.
[7] Source of historical data: FHLBB.

West, however, remain somewhat sluggish. The pace of new home sales was quite volatile during the third quarter, but these sales also increased about 13 percent from their previous trough.

Despite the increase in new home sales during the third quarter, one- to four-family starts remained at a subdued level, suggesting that an inventory correction was under way. As starts declined since 1986, builders' inventories of unsold new homes rose until March 1989 when the inventory/sales ratio rose to 68 percent, the highest level since the recession days of 1982. However, the relatively strong sales pace from July through September 1989 brought the inventory/sales ratio down to about 50 percent, a level that has been associated with increasing starts in the past. Indeed, single-family starts rose 7 percent in October.

Inventory correction over

We believe this inventory correction is largely over, and with mortgage interest rates expected to decline further, starts should continue to increase. For all of 1989, one- to four-family starts are likely to total 1.08 million units, down 5 percent from the 1988 level and nearly 15 percent below the 1986 peak for this recovery. While the 1989 level of one- to four-unit starts is expected to be below the 1988 level in all four regions, the sharpest declines are likely in the Northeast, down 11 percent, and the Midwest, down 7 percent. Smaller declines are expected in the South and West.

For 1990, we anticipate a 5 percent increase in one- to four-unit starts to 1.13 million units, with the West leading the way. In fact, the 1990 level of starts in the West is likely to surpass the 1986 level. The South and Midwest can expect smaller increases, while in the Northeast further declines are likely.

A similar pattern is expected in the resale market. Existing home sales improved further in the fourth quarter, bringing the 1989 total for the entire United States to 3.44 million units—4 percent below the 1988 level. Again, the steepest decline is expected in the Northeast. For 1990, an increase of 5 percent to 3.6 million units is likely, with the strongest gain occurring in the West.

We continue to believe that the improvement in housing activity in 1990 is likely to be relatively modest. One reason is that the real mortgage interest rate—the nominal mortgage rate minus the expected rate at which home prices appreciate—has risen sharply since early 1987 and will remain relatively high in 1990. Except for the West, rates of home price appreciation have slowed substantially. In the South and Midwest, home prices have been increasing on average just 3 to 5 percent per year for the past few years. In the Northeast, where annual rates of appreciation of 25 percent were common in 1987, appreciation has slowed to about 5 percent. Also, the underlying demographic demand for housing has been declining in the second half of the 1980s and will continue to decline for the next two decades. Furthermore, with the rate of economic growth slowing, the pace of job creation and employee relocation in 1990 will be much slower than during the previous three years.

High rental vacancy rates and the removal of tax incentives brought by the Tax Reform Act of 1986 have adversely affected construction of apartment buildings during the past several years. Recently, however, rental vacancy rates have finally begun to decline. In the South, where vacancies rose to more than 11 percent in late 1987, that rate is now down to 9½ percent. Similarly, in the West, the rental vacancy rate is down to 7 percent after peaking at around 8½ percent in mid-1988. In the Midwest and Northeast, vacancies peaked at 7 and 5 percent, respectively, and also appeared to be declining during 1989. Market absorption of new units is also improving. The percent of new units occupied within three months has risen to 68 percent from just 60 percent in early 1987.

Multifamily starts will rise

We expect that starts of multifamily units bottomed out in 1989 at about 320,000 units, 8 percent below the 1988 level. The Northeast, Midwest and West all experienced declines in 1989 from 1988. Surprisingly, multifamily starts in the South in 1989 are likely to be up about 4 percent above the 1988 level. This is a reflection of how large and diverse that region is. While the Oil patch states of Texas, Louisiana and Oklahoma are just beginning to emerge from a severe economic downturn, the Atlantic coast states of Maryland, Virginia, North and South Carolina, Georgia and Florida have experienced impressive economic growth during the 1980s.

In 1990, multifamily starts should rise about 6 percent to 340,000 units in response to lower mortgage interest rates and further declines in vacancies. However, it will take a few more years of relatively low production levels to bring this sector back into balance. And during the next decade, from a demographic standpoint, only about 400,000 multifamily units per year will be needed.

Nonresidential real estate has been subject to many of the same tax and economic factors as multifamily housing. This sector was overstimulated by the shortened depreciation periods of the Economic Recovery Tax Act of 1981 and the popularity of pass-through investment vehicles such as limited partnerships. Construction contract awards for commercial and industrial buildings soared after passage of that legislation, rising 80 percent from the fourth quarter of 1982 to a peak of 92 million square feet in the third quarter of 1985. Since then, contract awards have declined about 20 percent.

Office vacancy rates climbed in response to the high volume of new construction, with suburban office vacancy rates reaching nearly 24 percent in early 1987 and downtown office vacancy rates reaching nearly 17 percent in mid-1986. Although office construction has declined about 20 percent since 1985, vacancy rates have come down only a little, so the outlook for this sector is for further declines in new construction. Fortunately, investment in new retail space, warehouses, hotels and motels and industrial buildings has remained relatively strong.

But effective rates have since declined to around 10 percent, and prospects are quite good for further reductions in long-term interest rates in the months ahead. We expect FRM rates to decline to 9¼ to 9½ percent by mid-1990.

Overall, the prospects for the mortgage banking industry have improved substantially and look reasonably good for 1990. With both housing sales and refinancings responding to the decline in mortgage interest rates, we expect one- to four-unit originations will total approximately $390 billion in 1989, up 4 percent from the 1988 level.

With the return to a fixed-rate environment, mortgage bankers' market share also improved. Their market share likely averaged 25 percent in 1989, pushing the industry's origination volume up 15 percent to nearly $100 billion. Further increases in both total originations and market share are expected during 1990, with an additional 10 percent increase in the industry's origination volume to around $110 billion. **MB**

Lyle E. Gramley is senior staff vice president and chief economist and Richard W. Peach is staff vice president and deputy chief economist in the MBA Economics Department.

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VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

1989	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
	FHA New Homes[1]	CONVENTIONAL[2] FRM	CONVENTIONAL[2] ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
AUG	9.78%	10.30%	9.56%	8.08%	8.40%	9.95%	8.65%	9.99%
SEP	9.95	10.35	9.62	8.07	8.49	10.03	8.71	10.13
OCT	9.84	10.37	9.52	NA	8.30	9.81	8.62	9.95
NOV	**NA**	**NA**	**NA**	**NA**	**8.13**	**9.67**	**8.51**	**9.77**

SELECTED SECURITIES

1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
AUG	8.99%	8.57%	7.74%	8.18%	8.13%	8.11%	9.55%
SEP	9.02	8.70	7.74	8.22	8.26	8.19	9.56
OCT	8.84	8.53	7.62	7.99	8.02	8.01	9.39
NOV	**8.55**	**8.35**	**7.49**	**7.77**	**7.80**	**7.87**	**9.28**

CURRENT SECONDARY MARKET YIELDS

1989	GNMA[3]	FNMA[3]	FHLMC[3]
AUG	9.49%	9.53%	9.53%
SEP	9.52	9.54	9.53
OCT	9.40	9.42	9.42
NOV	**9.26**	**9.31**	**9.31**

SPREADS
(Basis Points)

1989	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
AUG	138%	142%	142%
SEP	133	135	134
OCT	139	141	141
NOV	**139**	**144**	**144**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

1989	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
JUL	$2,513	$2,091	$200,468	$5,464	$5,934	$6,606	$5,720	$5,180	$4,395	$4,895
AUG	2,842	2,724	203,923	5,081	7,852	5,706	7,283	8,650	6,161	5,463
SEP	2,328	2,223	208,894	6,883	7,979	7,708	7,880	8,050	5,181	5,740
OCT	**2,963**	**2,267**	**213,482**	**6,614**	**9,148**	**7,555**	**7,884**	**7,058**	**5,387**	**5,583**
1988 TOTAL	23,435	23,110	—	54,878	41,271	70,669	44,075	39,777	58,578	56,531
1987 TOTAL	25,415	20,531	—	63,230	68,210	76,615	76,840	75,018	116,611	96,983
10 MONTH AVG. 1989	2,238	1,716	—	5,091	6,721	6,750	6,221	5,786	4,481	4,639
1988	2,080	1,979	—	4,404	3,162	5,341	3,412	3,004	4,848	4,779
1987	1,940	1,549	—	5,415	6,368	7,272	7,060	6,908	10,834	8,760

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUL	1,420	1,083	337	1,281	979	302	189	274	531	426	160	232	478	411
AUG	1,329	1,046	283	1,328	1,004	324	140	236	563	390	174	263	517	374
SEP	1,268	1,020	248	1,319	1,012	307	166	248	480	374	170	254	509	386
OCT	**1,420**	**1,100**	**320**	**1,328**	**1,017**	**311**	**176**	**289**	**562**	**393**	**169**	**275**	**484**	**400**
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
10 MONTH AVG. (SAAR) 1989	1,405	1,077	327	1,336	1,009	327	190	270	549	395	185	259	506	387
1988	1,479	1,135	344	1,442	1,062	380	249	267	567	397	238	260	538	407
1987	1,655	1,240	415	1,569	1,136	434	277	312	638	429	277	297	585	412

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1989	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Avail' able for Sale	Months Supply At Current Sales Rate
JUL	3,330	2,260	8.2	738	369	6.1
AUG	3,480	2,330	8.0	726	365	6.3
SEP	3,520	2,320	7.9	652	366	7.1
OCT	**3,520**	**2,113**	**7.2**	**649**	**364**	**6.8**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
10 MONTH AVG. (SAAR) 1989	3,425	---	---	655	---	---
1988	3,550	---	---	679	---	---
1987	3,561	---	---	684	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

Total^5	1—Unit	2+ Units	Nonresidential
$274.5	$97.0	$20.0	$78.8
274.3	95.4	19.6	81.5
272.2	94.3	19.1	81.0
274.2	**95.0**	**19.3**	**81.8**
281.8	103.5	19.3	77.9
283.0	100.7	22.4	78.2
278.1	99.0	19.9	80.6
280.4	102.9	19.3	77.8
281.8	100.0	22.6	77.5

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 APR	$27,890	$5,530	$13,233	$8,730	$85	$2,480	$331	$1,206	$366	$221	$8,917	$122	$1,340	$5,216	$2,104
MAY	29,269	5,302	13,270	10,179	132	2,290	286	981	640	166	13,301	186	1,476	8,404	3,094
JUN	29,495	5,477	12,327	11,120	157	2,268	159	971	698	134	13,208	95	1,246	8,773	2,976
JUL	**27,273**	**5,522**	**10,819**	**10,390**	**200**	**1,733**	**296**	**680**	**407**	**222**	**15,597**	**135**	**835**	**12,533**	**1,967**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
7 MONTH AVG. 1989	27,466	5,372	12,518	9,075	108	2,396	274	1,169	536	183	11,716	109	1,353	8,048	2,075
1988	29,669	7,057	14,367	7,706	202	2,934	380	1,559	565	277	14,567	61	1,846	10,536	1,908
1987	42,001	11,088	18,575	11,747	318	4,221	209	1,859	836	266	12,902	307	2,048	8,575	1,885

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 JUL	153	92	14	47	94	$7,411	48	$3,060	13	$965	33	$3,366
AUG	177	110	18	49	105	8,208	55	3,511	14	1,102	35	3,595
SEP	147	85	16	46	116	8,981	68	4,326	13	1,033	35	3,622
OCT	**151**	**86**	**19**	**46**	**126**	**9,619**	**75**	**4,790**	**16**	**1,217**	**35**	**3,612**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
10 MONTH AVG. 1989	144	85	16	43	104	7,908	59	3,702	15	1,153	30	3,053
1988	151	82	18	51	114	8,316	60	3,654	18	1,307	36	3,355
1987	211	111	37	63	203	14,179	119	7,380	40	2,902	44	3,807

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[4] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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THE MAGAZINE OF REAL ESTATE FINANCE

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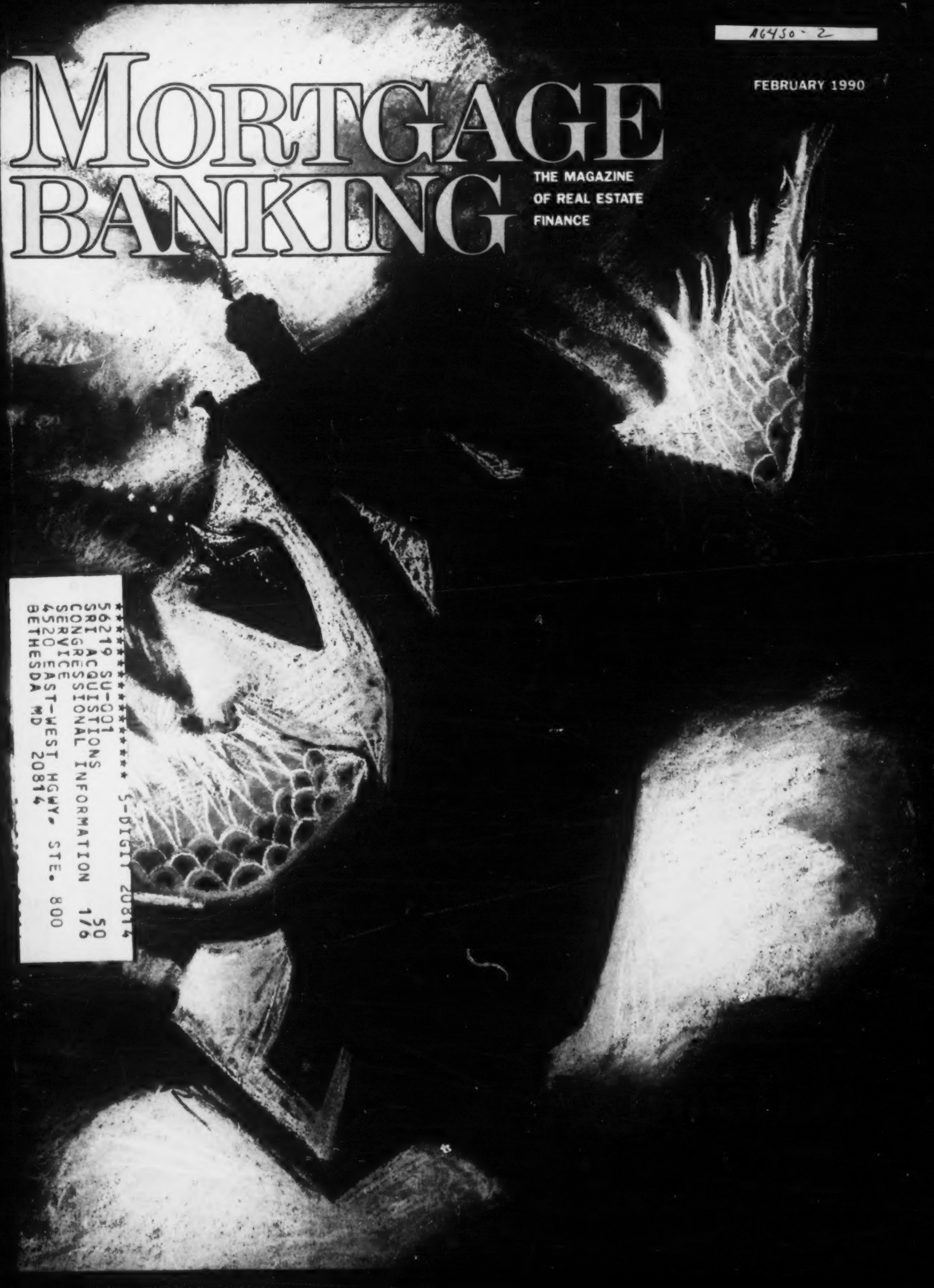

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COVER ILLUSTRATION BY REBECCA LEER

PORTFOLIO

A Cause for Celebration?

Automation is clearly a critical component of any mortgage operation. The benefits of automation are being felt on both the production and servicing fronts. Stark evidence that automation is paying its way on the servicing side emerges from the industry cost study just released by the Mortgage Bankers Association.

Two convincing signs of higher productivity during 1988 in the servicing operation will warm the heart of the industry's managers. The average number of loans serviced per servicing employee jumped by 46 loans in one year's time. In 1987, that average was only 570 loans. But in 1988, the average per servicing employee rose to 616 loans. This is the highest level of productivity since 1981, notes MBA's economics department—the authors of the study. The study profiled the top 10 most profitable firms amongst the respondents. This group posted on average 703 loans per servicing employee and boasted total direct costs that averaged 26 percent less than the other firms responding.

The other notable trend on the cost side was the finding that servicing personnel expenses dropped for the first time since 1984 on a per loan basis. Personnel expenses represent about 40 percent of the direct expenses tied to servicing. As one of the major controllable cost items in the servicing management equation these expenses are critical and obviously can make or break servicing profitability. On a per loan basis, personnel costs dropped by a full 8 percent in 1988 compared with 1987's figures.

The average cost of servicing a loan in 1988, accounting for direct expenses only, totaled $87.55. Personnel expenses per loan accounted for $37.63 of those costs in 1988, down from $40.84 in 1987.

Is this enough? Should servicing managers rest on their laurels and proclaim victory? Unfortunately that is not in the cards since foreclosure and delinquency problems continue to wage war on servicing profitability. In 1988, total expenses for problem loans were 11 percent higher than in 1987. Yet, even with the profit drain tied to bad loans, the final tally for 1988 showed that net income per loan serviced rose to $49.36—a rise of almost 32 percent over 1987's dismal showing. Not bad, but let's wait for 1989's numbers before we buy the confetti.

Janet Reilley Hewitt
Editor

COMING IN MARCH

A whirlwind of reform is clouding the housing legislative outlook. Lawmakers in Washington are bent on a mission to scrutinize all government-related housing programs and tighten as many screws as they can—loose or otherwise. Next month we will talk about what's ahead and what's already been done on the housing legislative front.

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Offsetting otherwise gloomy profitability results, MBA's cost study showed net income from servicing in 1988 rose 32 percent for the average reporting firm.

THE 1988
SERVICING PROFIT PICTURE

Robert M. Rosenblatt

Profitability in mortgage lending in 1988 was little better than in 1987, as the industry continued its efforts to cope with difficult environmental conditions. Loan origination volume remained deeply depressed during 1988, and the costs of handling delinquent and foreclosed loans were once again exceptionally high. Rising short-term interest rates, which increased the costs of carrying mortgages in warehouse, added to the problems of maintaining profitability.

For the 114 mortgage banking firms that provided detailed 1988 statistics on income and costs by mortgage banking function, the average pretax profit margin (net income per dollar of gross revenue) was 1.7 percent in 1988, barely above the meager 1987 level. Profit margins were increased to 14.3 percent by sales of servicing, but of course this entails a sacrifice of future income to bolster current profitability. (See Table 1)

Sustaining profitability was as difficult for larger firms as for smaller companies. Thus, profit margins at firms originating more than $500 million in loans were slightly negative, as they were also at firms originating less than $100 million in loans. While companies originating from $100 million to $500 million in loans were somewhat more profitable, the variations in profitability among firms within these size groups is too large for this result to be significant.

Gloomy as these results are, the aggregate data on profitability in single-family residential lending during 1988 contain some elements of hope. For one thing, net income from servicing at the average reporting firm rose 32 percent from a very depressed level in 1987. Successful efforts to control direct servicing costs were a major contributor to this improvement. Second, some firms demonstrated once again that good levels of profitability can be sustained even in a harsh environment. For example, of the firms reporting in both the 1987 and 1988 surveys of income and expenses, the 10 most profitable achieved an average profit margin of about 15 percent in both years. This is below the industry-wide average for good years such as 1986, but is very close to the industry-wide average for the past decade.

After suffering through two extremely difficult years, profitability from the servicing operation improved in 1988. While mortgage bankers still have a long way to go to regain satisfactory levels of profitability in servicing, information from this survey indicates that many firms are learning to cope with the difficulties they face in a highly competitive business environment.

> **After suffering through two extremely difficult years, profitability from the servicing operation improved in 1988.**

Net income per loan serviced rose to $49.36 in 1988, from $37.49 in 1987, an increase of nearly 32 percent. One contributor to this improvement was the continued increase in gross income. Total servicing income, at $211.44 per loan, was 8 percent higher in 1988 than in 1987. But the main reason for this progress was the stability in total servicing costs. In 1988, total costs rose only 2 percent to $162.08 per loan. In sharp contrast, servicing costs per loan had jumped 18 percent in the previous year. The key to holding down overall expenses was the 10 percent drop in direct costs to $87.55 per loan, reflecting an increase in productivity. The number of loans serviced per servicing employee rose from 570 loans in 1987 to 616 loans in 1988, or by 46 loans per employee. This is the highest level of productivity since 1981. Moreover, in 1988, 17 percent of the firms in the survey serviced at least 700 loans per servicing employee. In 1987, only 11 percent of the sample achieved this level of productivity.

The 1988 rise in profitability in servicing was the first in four years. In 1988, the profit margin (net income divided by gross income) for the servicing operation increased by 4 percentage points to 23 percent. Nonetheless, profitability is still quite low by historical standards. As recently as 1985, the profit margin for servicing was 42 percent, and for the period 1980-1985, the profit margin averaged 49 percent per year. A major reason for the deterioration recently has been the heavy losses associated with delinquency and foreclosure problems. Total servicing expenses related to problem loans rose again in 1988, this time by 11 percent, to $37.42 per loan. (See Table 2)

Servicing Income

Total servicing income rose by 8 percent to $211.44 per loan in 1988 as compared with $195.81 per loan in the previous year. As a result, servicing income as a percent of the dollar volume serviced rose to 45 basis points, 2 basis points higher than in 1987, and equal to the average for the 1980s. Within servicing income, servicing fee income, the most stable and important part of most servicing operations, rose 3.4 percent to $183.60 per loan, while other loan administration income increased by 28 percent to $29.80 per loan. Furthermore, losses on sales of real estate owned (REO) were only ($1.96) per loan in 1988 as compared with ($5.08) per loan in 1987, an improvement of $3.12 per loan. However provision for loan losses, an element of costs, rose significantly in 1988.

> Total servicing income rose by 8 percent to $211.44 per loan in 1988 as compared with $195.81 per loan in the previous year.

In addition to the traditional sources of revenue generation previously mentioned, a broader understanding of the growth of servicing income today requires taking into account the buying and selling of servicing rights, a practice that has become more prevalent in recent years. Estimates reveal that in 1985 about $80 billion in servicing rights changed hands. By 1988, this figure had almost doubled to $150 billion, and given the current state of the industry, increases are likely to continue.

This increase in servicing transfers reflects ongoing structural changes taking place within the industry. Increased specialization has led many firms to sell their originations servicing released, and others to become exclusively servicers. Consequently, transfers of servicing rights are becoming a standard part of the servicing operation at many institutions. Sales of servicing can be used to generate additional cash to fund losses associated with problem loans, or pay off long-term debt. Just as important, firms can use sales of servicing to restructure their servicing portfolios, in order to obtain an optimum mix between low delinquency and high average loan balance loans. Finally, since servicing trades are now occurring in much smaller denominations in some cases as little as $25 million many small and mid-sized companies, who in the past had been shut out of the market by the sheer size of the transfers being negotiated, may now participate.

TABLE 1

Income and Expenses Per Firm (in Thousands)
Average Firm, 1986–1988

	1988	1987	1986
Gross Income, Total	**$24,187**	**$26,066**	**$25,837**
Loan Production	4,529	5,712	5,059
Warehousing	8,104	8,979	9,602
Marketing	345	1,770	3,142
Servicing	11,209	9,605	8,035
Servicing, Including Sales of Servicing	14,759	N/A	N/A
Expenses, Total	**$23,767**	**$25,880**	**$20,765**
Loan Production	9,593	11,023	8,222
Warehousing	5,410	6,699	6,258
Marketing	172	394	313
Servicing	8,592	7,764	5,972
Net Income, Total (Before Tax)	**$ 420**	**$ 186**	**$ 5,072**
Loan Production	(5,064)	(5,311)	(3,163)
Warehousing	2,694	2,280	3,344
Marketing	173	1,376	2,829
Servicing	2,617	1,841	2,063
Servicing, Including Sales of Servicing	6,167	N/A	N/A
Memorandum Items:			
Profit Margin (Before Tax)	1.7	0.7	19.6
Profit Margin, Including Sales of Servicing (Before Tax)	14.3	N/A	N/A
Purchased Production as Percent of Total Production	31	33	35
Number of Firms Reporting	114	124	124

TABLE 2

Servicing Income and Expenses Per Loan Serviced Average Firm, 1986–1988

	1988	1987	1986
INCOME			
Servicing Fees	**$183.60**	**$177.60**	**$161.12**
First Mortgages[1]	194.01	173.92	160.65
Other Mortgages	0.34	3.68	0.47
Amortization of Excess Servicing	(10.75)	N/A	N/A
Net Gain (or Loss) on Sale of REO	(1.96)	(5.08)	(10.49)
Other Loan Administration Income	29.80	23.29	29.90
Total Servicing Income	$211.44	$195.81	$180.53
Net Gain (or Loss) on Sale of Servicing	66.97	N/A	N/A
Total Servicing Income, Including Net Gain (or Loss) on Sale of Servicing	$278.41	N/A	N/A
EXPENSES			
Personnel	**$ 37.63**	**$ 40.84**	**$ 37.63**
Loan Administration Employees	30.44	33.56	31.25
Management and Directors	0.68	1.11	0.21
All Other Personnel	0.42	0.39	0.86
Fringe Benefits	5.94	5.63	5.08
Education and Training	0.15	0.15	0.23
Occupancy	**5.67**	**5.38**	**4.58**
Electronic Data Processing	**8.69**	**10.14**	**9.05**
Other Direct expenses	**35.56**	**41.46**	**31.66**
Expenses to Service Foreclosures and REO	8.07	15.14	N/A
Corporate Interest Losses on MBS Pools	2.99	N/A	N/A
Equipment Rentals and Depreciation, Excluding EDP	1.22	1.57	1.67
All Other Direct Expenses	23.28	24.75	29.99
Total Direct Expenses	**$ 87.55**	**$ 97.82**	**$ 82.92**
Provision for Loan Losses	**27.39**	**13.41**	**12.19**
Amortized Cost of Purchased Servicing	**47.14**	**47.09**	**39.46**
Net Servicing Income (Before Tax)	**$ 49.36**	**$ 37.49**	**$ 45.96**
Memorandum Items:			
Servicing Profit Margin (Before Tax)	23.3	19.1	25.5
Servicing Profit Margin, including Net Gain (or Loss) on Sale of Servicing (Before Tax)	41.8	N/A	N/A
Servicing Income as Percent of Dollar Volume Serviced	0.451	0.428	0.438
Servicing Fees as Percent of Dollar Volume Serviced	0.392	0.388	0.390
Servicing Expense Ratio[2]	0.187	0.214	0.201
Number of Firms Reporting	114	124	124

[1] 1988 servicing fees on first mortgages represent gross servicing fees. In prior years, they represented servicing fees on first mortgages less amortization of excess servicing. This year amortization of excess servicing is a separate line item. Comparisons can still be made between total servicing fee income.

[2] Total Direct Expenses as a percent of dollar volume serviced.

Given the increased importance of transfers of servicing rights, this year's survey for the first time sought to capture the gains (losses) related to the sales of servicing rights. On a per loan basis, revenues from sales of servicing averaged $66.97 in 1988. Thus, when this short-run stimulant to income is included, net servicing income more than doubles to $116.33 per loan at the average firm. In addition, when including gains from sales of servicing, the profit margin from the servicing operation jumped to 42 percent.

Based on responses to the survey, small firms tend to be net sellers of servicing rights, while large servicers are usually net purchasers. The servicing acquisition ratio (SAR) illustrates this point. The SAR represents the net gain in servicing volume relative to the volume of servicing rights generated through in-house and purchased originations. The SAR for the average firm in 1988 was 1.01, which essentially means that the volume of loans added to the servicing portfolio, approximately equalled the volume of loans originated by the firm. But, for companies with servicing portfolios of less than $1 billion, the SAR was only 0.38, indicating they were net sellers of servicing rights. While for companies with servicing portfolios greater than $4 billion, the SAR was 1.47, signifying that they are net purchasers of servicing rights. (See Table 3).

Servicing expenses

In 1988, for the first time in five years, total servicing costs remained essentially unchanged. On a per loan basis, total servicing expenses were $162.08 in 1988, as compared to $158.32 in 1987, an increase of only 2 percent. This stability contrasts sharply with the average for the 1980-1987 period, when total servicing expenses rose about 17 percent per year.

Servicing costs can be broken down into three broad areas; direct expenses, provision for loan losses, and the amortized cost of purchased servicing (ACPS). In 1988, direct expenses declined by 10½ percent, and the ACPS was unchanged. But, these were offset by a twofold increase in provision for loan losses.

Direct expenses fell to $87.55 per loan in 1988. As a percent of dollar volume serviced, direct expenses declined to 19 basis points, 2 basis points below the 1987 level, and 1 basis point lower than in 1986. This decline is welcome news, and indicates that the concerted efforts of servicing managers to contain the basic costs related to servicing are bearing fruit.

Within direct expenses, personnel costs, which account for about 40 percent of direct expenses, declined for the first time since 1984. On a per loan basis, personnel expenses fell by 8 percent in 1988 to $37.63, from $40.84 in the prior year. Combining this drop with the rise in servicing volume means that as a percent of dollar volume serviced, personnel costs were only 8 basis points in 1988, the lowest they have been in the 1980s. (See Table 4).

TABLE 3

1988 Servicing Income and Expenses per Loan Serviced Grouped by Dollar Volume of Loans Serviced

	Less than $500 Million	$500 Million to $999 Million	$1 Billion to $3.99 Billion	$4 Billion or More	Average Firm
INCOME					
Servicing Fees	**214.91**	**$202.14**	**$188.08**	**$178.84**	**$183.60**
First Mortgages[1]	221.70	226.43	200.48	187.28	194.01
Other Mortgages	0.94	0.13	1.11	0.01	0.34
Amortization of Excess Servicing	(7.73)	(24.42)	(13.51)	(8.45)	(10.75)
Net Gain (or Loss) on Sale of REO	**(4.89)**	**(4.09)**	**(4.07)**	**(0.74)**	**(1.96)**
Other Loan Administration Income	**27.91**	**28.63**	**27.56**	**30.95**	**29.80**
Total Servicing Income	**$237.93**	**$226.68**	**$211.57**	**$209.05**	**$211.44**
Net Gain (or Loss) on Sale of Servicing	**106.32**	**91.08**	**83.79**	**56.07**	**66.97**
Total Servicing Income, Including Net Gain (or Loss) on Sale of Servicing	**$344.25**	**$317.76**	**$295.36**	**$265.12**	**$278.41**
EXPENSES					
Personnel	**$ 59.62**	**$ 49.48**	**$ 38.86**	**$ 35.24**	**$ 37.63**
Loan Administration Employees	49.93	41.34	31.57	28.25	30.44
Management and Directors	1.90	0.76	0.21	0.84	0.68
All Other Personnel	0.00	0.65	1.10	0.12	0.42
Fringe Benefits	7.50	6.49	5.71	5.94	5.94
Education and Training	0.29	0.24	0.27	0.09	0.15
Occupancy	**8.58**	**8.08**	**5.48**	**5.43**	**5.67**
Electronic Data Processing	**11.40**	**12.40**	**8.63**	**8.28**	**8.69**
Other Direct Expenses	**37.80**	**46.00**	**31.11**	**36.47**	**35.56**
Expenses to Service Foreclosures and REO	6.29	10.13	5.99	8.85	8.07
Corporate Interest Losses on MBS Pools	1.13	6.36	3.37	2.59	2.99
Equipment Rentals and Depreciation, Excluding EDP	1.87	2.22	1.40	1.03	1.22
All Other Direct Expenses	28.51	27.29	20.35	24.00	23.28
Total Direct Expenses	**$117.40**	**$115.96**	**$ 84.08**	**$ 85.42**	**$ 87.55**
Provision for Loan Losses	**3.60**	**15.72**	**9.66**	**36.99**	**27.39**
Amortized Cost of Purchased Servicing	**24.23**	**26.93**	**33.21**	**55.83**	**47.14**
Net Servicing Income (Before Tax)	**$ 92.70**	**$ 68.07**	**$ 84.62**	**$ 30.81**	**$ 49.36**
Memorandum Items:					
Servicing Fee (%)	0.419	0.421	0.394	0.387	0.392
Number of Loans Serviced per Servicing Employee	415	459	626	644	616
Average Loan Size Serviced	$51,260	$48,059	$47,700	$46,231	$46,863
Average Number of Loans Serviced	4,086	15,145	44,125	215,266	53,008
Average Dollar Volume of Servicing (Millions)	$ 209	$ 728	$ 2,105	$ 9,952	$ 2,484
Percent Growth, Dollar Volume of Servicing	13.4	6.9	6.1	15.7	12.4
Servicing Acquisition Ratio	0.473	0.236	0.761	1.474	1.008
Number of Firms Reporting	35	23	38	18	114

[1] 1988 servicing fees on first mortgages represent gross servicing fees. In prior years, they represented servicing fees on first mortgages less amortization of excess servicing. This year amortization of excess servicing is a separate line item. Comparisons can still be made between total servicing fee income.

The reduction in personnel costs reflects both a small rise in salaries for loan administration employees and staff cutbacks. Average salaries for servicing employees increased only 3.6 percent in 1988 to $18,978. This follows much larger increases of 9 percent and 10 percent in the previous two years. But also important was the drop in employment. At the average firm, the number of loan administration employees fell by 4 percent, to 88 employees.

Occupancy expenses did go up by 5.4 percent in 1988, to $5.67 per loan. However, the size of this increase compares quite favorably with the substantial increases recorded in 1986 and 1987, when occupancy expenses rose 17 percent and 25 percent, respectively. Moreover, given the rise in servicing volume, occupancy expenses as a percent of dollar volume serviced remained unchanged at 12 basis points.

In another key area of direct expenses, electronic data processing (EDP) costs per loan reversed their upward trend, falling for the first time in five years. In 1988, EDP expenses per loan declined 14 percent to $8.69. This drop may be the result of the slowdown in mortgage loan prepayments. Heavy prepayment activity, such as occurred in 1986 and 1987, requires an abnormally large number of computer inquiries, that are costly and can push up EDP expenses. With the drop in loan refinancings in 1988, computer usage may have returned to more normal levels. But it also might reflect the increased use of more cost-effective technologies including optical disks for data management, power dialing and computer voice response systems to increase operating efficiency.

Finally, other direct expenses fell about 14 percent to $35.56 per loan. This drop mainly reflects a decline in expenses to service foreclosures and REO. Other components of this category also declined modestly.

As expected given the increases in sales of servicing, the ACPS component of expenses has jumped to a new level in the past few years. In 1980, the ACPS represented only 19 percent of total costs, by 1988 it had increased to 29 percent. On a per loan basis, the ACPS was $47.14 in 1988, essentially the same as in 1987, but still almost three times as much as the 1980-1985 average. Lower mortgage prepayments in 1988 may have helped to hold down the ACPS component of expenses, because the unamortized portion of the costs of purchased servicing must be written off as expenses when loans are removed from the books through repayment.

The servicing operation continued to be plagued by heavy losses related to delinquency and foreclosure problems in 1988. In 1988, total expenses for problem loans which includes provision for loan losses, losses on sales of REO, and expenses to service foreclosures and REO was $37.42 per loan, 11 percent higher than the $33.63 figure recorded in the prior year. All of the increase was in provision for loan losses, which more than doubled, rising to $27.39 per loan in 1988, from $13.41 per loan in 1987. Provision for loan losses in 1988 represented 17 percent of total servicing expenses; in 1980, they accounted for only 1 percent of total costs. The other two costs associated with problem loans improved in 1988. Losses from sales of REO were only ($1.96) per loan in 1988 as compared with ($5.08) per loan in the prior year. Furthermore, expenses to maintain foreclosed properties was nearly cut in half, dropping to $8.07 per loan in 1988 from $15.14 per loan in 1987. (See Table 5).

Heavy use of the no-bid option on VA foreclosures continued to be a major factor in foreclosure costs. During 1988, VA foreclosures rose another 10 percent to 47,712 loans, and no-bids represented a higher proportion of the total. The no-bid option was utilized in 24 percent of the VA foreclosures in 1988 as compared with 21 percent in 1987. Given that losses from a no-bid foreclosure were between $15,000 to $20,000, this trend is critical to mortgage bankers, who service an estimated 70-75 percent of all VA loans. Fortunately, evidence from other sources indicates that the no-bid situation stabilized in 1989.

As in past years, economies of scale continued to be evident in 1988, with the larger firms tending to have both higher levels of productivity and lower direct costs. For instance, at firms with servicing portfolios of less than 5,000 loans, the number of loans serviced per servicing employee was only 366, while at firms with servicing portfolios greater than 70,000 loans, the number of loans serviced per servicing employee was 644. Further support for this view can be found by comparing the most productive servicers with their less efficient competitors. At companies where the number of loans serviced per servicing employee was greater than 700, the average dollar volume serviced was $4.7 billion. In contrast, at firms with less than 400 loans serviced per servicing employee, servicing volume averaged only $480 million.

As expected, these differences in productivity dramatically affect direct costs, with the most efficient servicers having the lowest direct costs on a per

TABLE 4

Miscellaneous Servicing Expenses

	1988	1987	1986	1985
Personnel Expenses, 1985–1988				
Number of Loans Serviced per Servicing Employee	616	570	549	579
Average Salary Loan Administration Personnel	$18,978	$18,324	$16,774	$15,187
Total Personnel Expenses per Loan Serviced	$ 37.64	$ 40.84	$ 37.62	$ 33.58
Personnel Expense as a Percent Dollar Volume Serviced	0.080	0.089	0.091	0.090
Personnel Expense as a Percent of Total Direct Servicing Expense	43	42	45	51
Other Expenses, 1985–1988				
Occupancy Expenses per Loan Serviced	$ 5.67	$ 5.38	$ 4.58	$ 3.68
Occupancy Expenses per Loan Administration Employee	$ 3,487	$ 2,905	$ 2,393	$ 2,053
Occupancy as a Percent of Dollar Volume Serviced	0.012	0.012	0.011	0.010
EDP Expense per Loan Serviced	$ 8.69	$ 10.14	$ 9.05	$ 6.68
EDP Expense per Loan Administration Employee	$ 5,342	$ 5,473	$ 4,727	$ 3,747
EDP Expense as a Percent of Dollar Volume Serviced	0.019	0.022	0.022	0.018
Other Direct Expenses per Loan Serviced	$ 35.56	$ 41.46	$ 31.65	$ 22.11
Other Direct Expenses as a Percent of Dollar Volume Serviced	0.076	0.091	0.077	0.059

TABLE 5

Trends in Servicing Costs Average Firm, 1979- 1988

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Selected Expenses per Loan:										
Provision for Loan Losses	$0.29	$ 0.48	$ 0.86	$ (0.09)	$ 2.43	$ 4.20	$ 4.98	$12.19	$13.41	$27.39
Net Losses on Foreclosures	$0.28	$ 0.16	$ 0.92	$ 1.11	$ 1.75	$ 4.99	$ 6.77	$10.49	$ 5.08	$ 1.96
Amortized Cost of Purchased Servicing	$6.25	$10.25	$10.58	$15.03	$17.88	$20.15	$23.88	$39.46	$47.09	$47.14
Expenses to Service Foreclosures and REO	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	$15.14	$ 8.07

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TABLE 6

**Servicing Income and Expenses per Loan Serviced
Ten High-Profit Firms, 1987–1988**

	1988	1987
INCOME		
Servicing Fees	$195.06	$173.91
Net Gain (or Loss) on Sale of Reo	(1.29)	(1.53)
Other Loan Administration Income	25.22	24.16
Total Servicing Income	$218.99	$196.54
Net Gain (or Loss) on Sale of Servicing	26.44	N/A
Total Servicing Income, Including Net Gain (or Loss) on Sale of Servicing	$245.43	N/A
EXPENSES		
Personnel	$ 32.26	$ 32.08
Occupancy	3.65	2.72
Electronic Data Processing	5.71	4.78
Other Direct Expenses	23.41	20.79
Total Direct Expenses	$ 65.03	$ 60.37
Provision for Loan Losses	0.23	0.41
Amortized Cost of Purchased Servicing	4.59	2.51
Net Servicing Income (Before Tax)	$149.04	$133.25

loan basis. At firms with at least 700 loans serviced per servicing employee, direct costs per loan were only $63.33. Conversely, at firms with less than 400 loans serviced per servicing employee, direct costs per loan were $160.46.

Finally, in servicing, as in other areas of mortgage banking, some firms tend to outperform the rest. An examination of the 10 most profitable repeat reporters reveals that, in servicing, the key distinction between them and the other survey respondents was their substantially lower expense figures. Total servicing income was quite similar. At $218.99 per loan, servicing income for this group of 10 companies was only 4 percent higher than at the average firm.

> In 1988, for the first time in five years, total servicing costs remained essentially unchanged.

On the other hand, total servicing expenses for these 10 companies were $69.95 per loan, less than half of what they were at the average firm. All three of the broad cost areas were significantly lower for the high profit firms. Direct expenses were only $65.03 per loan, 26 percent less than at the average firm. Higher levels of productivity accounted for much of the difference. For the high profit firms, the number of loans serviced per servicing employee was 703, 14 percent higher than at the average firm. But even more important was the fact that the servicing portfolios for these 10 firms were composed of very high quality loans. Conse- quently, problem loan expenses were just $3.52 per loan, or only 5 percent of their total costs. At the average firm, problem loan expenses were $37.42 per loan, which represented 23 percent of costs. Finally, these 10 firms were not actively involved in the buying or selling of servicing rights. Thus, the ACPS component of expenses as well as the gains from sales of servicing were extremely low. As a result of these cost advantages, net servicing income for these 10 high profit firms was $149.04 per loan, three times higher than at the average firm. (See Table 6). **MB**

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VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

1989	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
SEP	9.95%	10.35%	9.62%	8.07%	8.49%	10.03%	8.71%	10.13%
OCT	9.84	10.37	9.52	8.01	8.30	9.81	8.62	9.95
NOV	9.71	10.36	9.39	NA	8.13	9.67	8.51	9.77
DEC	**NA**	**NA**	**NA**	**NA**	**8.00**	**9.67**	**NA**	**NA**

SELECTED SECURITIES

1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	U.S. GOVERNMENT 6-Month	1-Year	3-Year	10-Year	A-Rated Utility
SEP	9.02%	8.70%	7.74%	8.22%	8.26%	8.19%	9.55%
OCT	8.84	8.53	7.62	7.99	8.02	8.01	9.39
NOV	8.55	8.35	7.49	7.77	7.80	7.87	9.28
DEC	**8.45**	**8.29**	**7.42**	**7.72**	**7.77**	**7.84**	**9.36**

CURRENT SECONDARY MARKET YIELDS

1989	GNMA[3]	FNMA[3]	FHLMC[3]
SEP	9.52%	9.54%	9.53%
OCT	9.40	9.42	9.42
NOV	9.26	9.31	9.31
DEC	**9.26%**	**9.34%**	**9.32%**

SPREADS

(Basis Points)

1989	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
SEP	133	135	134
OCT	139	141	141
NOV	139	144	144
DEC	**142**	**150**	**148**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

1989	FNMA Portfolio Commitments	FNMA Portfolio Purchases	FNMA Mortgage-Backed Securities Out-Standing	FNMA Mortgage-Backed Securities Issued	FHLMC Commitments To Sell	FHLMC Commitments To Buy	FHLMC Mortgages Purchased	FHLMC PCs Issued	GNMA Pass-Through Securities Applications	GNMA Pass-Through Securities Issued
JUL	$2,513	$2,091	$200,468	$5,464	$5,934	$6,608	$5,720	$5,180	$4,395	$4,895
AUG	2,842	2,724	203,923	5,081	7,852	5,705	7,283	8,650	6,161	5,463
SEP	2,328	2,223	208,894	6,883	7,979	7,708	7,889	8,050	5,181	5,740
OCT	**2,963**	**2,267**	**213,482**	**6,614**	**9,148**	**7,555**	**7,884**	**7,058**	**5,387**	**5,583**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
10 MONTH AVG. 1989	2,238	1,716	---	5,091	6,721	6,750	6,221	5,786	4,481	4,639
1988	2,080	1,979	---	4,404	3,162	5,341	3,412	3,004	4,848	4,779
1987	1,940	1,549	---	5,415	6,368	7,272	7,060	6,908	10,834	8,760

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	**Total**	**1-4 Units**	**5+ Units**	**Total**	**1-4 Units**	**5+ Units**	**Northeast**	**Midwest**	**South**	**West**	**Northeast**	**Midwest**	**South**	**West**
AUG	1,329	1,046	283	1,328	1,004	324	140	236	563	390	174	263	517	374
SEP	1,264	1,028	236	1,319	1,012	307	161	248	486	369	170	254	509	386
OCT	1,428	1,085	343	1,356	1,025	331	180	294	558	396	172	276	492	416
NOV	**1,361**	**1,066**	**295**	**1,333**	**1,039**	**294**	**186**	**305**	**495**	**375**	**171**	**276**	**487**	**399**
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
11 MONTH AVG. (SAAR)														
1989	1,401	1,076	325	1,339	1,013	326	189	274	545	393	184	260	505	390
1988	1,487	1,142	345	1,448	1,066	382	246	267	571	403	234	259	541	414
1987	1,656	1,234	422	1,559	1,128	431	276	314	638	428	276	294	581	409

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1989	**Sold (SAAR)**	**Available for Sale**	**Months Supply At Current Sales Rate**	**Sold (SAAR)**	**Available for Sale**	**Months Supply At Current Sales Rate**
AUG	3,480	2,330	8.0	723	364	6.3
SEP	3,520	2,320	7.9	642	366	7.2
OCT	3,480	2,170	7.5	648	366	6.9
NOV	**3,590**	**2,420**	**8.1**	**710**	**365**	**6.3**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
11 MONTH AVG. (SAAR)						
1989	3,436	---	---	659	---	---
1988	3,565	---	---	677	---	---
1987	3,544	---	---	679	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

1989	**Total[6]**	**1-Unit**	**2+ Units**	**Nonresidential**
AUG	$276.3	$95.3	$19.6	$83.2
SEP	274.5	94.2	19.0	83.0
OCT	274.5	94.9	18.1	83.0
NOV	**274.1**	**96.2**	**19.0**	**82.3**
1988 TOTAL	281.8	103.5	19.3	77.9
1987 TOTAL	283.0	100.7	22.4	78.2
11 MONTH AVG. (SAAR)				
1989	278.3	98.7	19.7	81.3
1988	280.3	103.3	19.3	77.6
1987	282.4	100.3	22.5	77.9

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 JUN	$29,396	$5,477	$11,984	$11,445	$76	$2,471	$159	$962	$881	$163	$13,150	$95	$1,209	$9,627	$2,102
JUL	25,881	5,522	10,452	9,365	200	1,789	296	635	508	222	17,345	135	791	14,325	1,967
AUG	31,614	6,150	13,215	11,752	113	2,580	329	870	1,033	223	13,884	269	971	10,670	1,913
SEP	**31,406**	**5,592**	**12,708**	**12,529**	**114**	**2,393**	**678**	**772**	**534**	**229**	**11,254**	**226**	**815**	**8,210**	**1,805**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
9 MONTH AVG. 1989	28,174	5,483	12,352	9,841	99	2,444	325	1,066	647	191	12,324	139	1,224	9,062	1,767
1988	31,541	7,461	15,451	8,036	244	3,031	355	1,642	569	298	14,327	78	1,894	10,146	2,009
1987	40,136	10,138	18,148	11,268	295	3,949	198	1,865	744	275	13,160	277	2,058	8,684	2,032

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 AUG	177	110	18	49	105	$8,208	55	$3,511	14	$1,102	35	$3,595
SEP	147	85	16	46	116	8,981	68	4,326	13	1,033	35	3,622
OCT	151	86	19	46	126	9,619	75	4,790	16	1,217	35	3,612
NOV	**136**	**78**	**18**	**40**	**131**	**9,936**	**82**	**5,240**	**17**	**1,326**	**32**	**3,370**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
11 MONTH AVG. 1989	142	84	16	42	106	8,091	61	3,842	15	1,168	30	3,081
1988	148	81	17	50	112	8,196	58	3,552	18	1,309	36	3,335
1987	204	106	36	62	203	14,179	114	7,381	39	2,891	43	3,761

NA—Not Available. SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

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[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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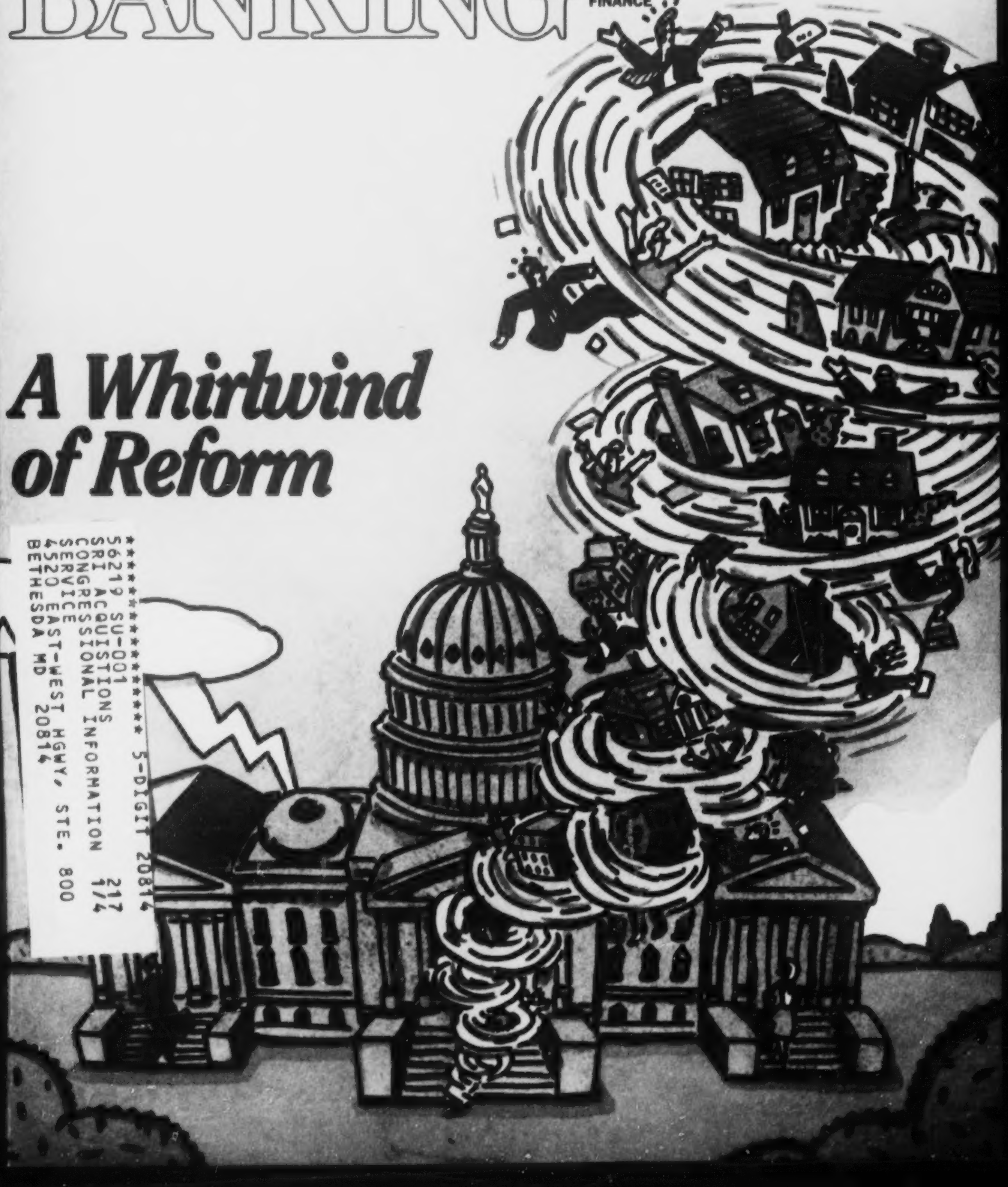
MORTGAGE BANKING

THE MAGAZINE
OF REAL ESTATE
FINANCE

MARCH 1990



A Whirlwind of Reform

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COVER: Legislative Issues

The Congress got caught up in a whirlwind of reform last year after having to clean house in the thrift industry with the taxpayers footing the bill. The well publicized HUD scandals further fanned the fires of reform on Capitol Hill. As a result, all housing-related legislation is being scrutinized from a new vantage point with a much sterner grip on the federal housing purse strings.

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PORTFOLIO

Washington Watch

The "Keating Five," the S&L bailout price tag, Kemp and the GOP activist social agenda, the taxpayer's burden, HUD scandals, the Reagan Revolution and financial deregulation, the legacy of "Silent Sam," the health of the FHA insurance funds and potential budget vulnerability from the activities of the so-called government-sponsored entities (read FANNIE MAE, FREDDIE MAC AND GNMA). These are the key components that will shape the outlook for housing legislation in the months ahead. The individual spin that each legislator puts on these headlines and the connection between the events themselves in the eyes of elected representatives will be the foundation upon which housing policy will be forged in the near term.

The media plays a major role in connecting the news dots to paint the larger picture of cause and effect. To portray the powerful influence that the national news media has on lawmakers in Washington, our cover story revisits the making of the HUD reform act. This legislation was moved along by the powerful airwaves that brought the extent of lax management at HUD in certain program areas to the American T.V. audience almost daily last summer. The result was remedial legislation that moved so quickly through Congress it spun heads.

In this issue, we also focus on the opportunity that currently exists in Washington to pass important new housing legislation riding on the currents of activist change being fanned by a very dynamic and impassioned HUD secretary. Interestingly, if you dissect the different crosscurrents that are creating this legislative opportunity, it is a conservative Republican HUD secretary noted for preaching from the bible of private-sector solutions, along with a Roosevelt-style Democrat in the House, who will be the prime movers of any new housing legislation moved through Congress this year. Other key actors on the Senate side will be those under the shadow of the Charles Keating affair. Indeed, the S&L bailout and the mounting costs arising from that complete regulatory breakdown, just might prove the most influential player of all in the halls of Congress this year determining the key federal changes that will occur to help our nation become better housed.

Janet Reilley Hewitt
Editor

COMING IN APRIL

The dramatic boom in the wholesale mortgage banking business is reshaping the production side of the industry. Our lead story in April charts the rise in wholesale production during the last few pace-setting years. We will also run an interview with C. Austin Fitts, a new breed of manager at the helm of the FHA.

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ECONOMIC TRENDS

Although many would like to, few mortgage bankers can forget 1987, the industry's worst year in recent history. From the soaring profit margins of 1986, profits plunged to barely above zero in 1987 in the wake of declining origination volume and higher interest rates. Since then the industry has been working hard to contain costs and improve profitability. Recent evidence suggests that maybe, just maybe, the industry has turned the corner.

The evidence is the performance in the third quarter of 1989 of the 11 firms that responded to MBA's Ratio Analysis Survey (RAS) for this quarter and the third quarter of 1988. On average, between the third quarters of 1988 and 1989, these 11 firms increased productivity in origination and servicing, contained costs in these areas and improved overall profitability.

With the largest cost component of a mortgage banker's operation, personnel expenses, continuing to increase over the period (see accompanying Table), the firms in the sample continued their efforts to combat these rising costs by scaling down or consolidating their operations and, in some cases, changing their overall focus from predominantly retail to wholesale lending. Between the third quarter of 1988 and the third quarter of 1989, staffs at these 11 firms were cut by an average of eight employees per firm. The largest declines were in the origination function where the number of origination employees was slashed by an average of 35 employees per firm. Servicing staffs were also reduced, falling by an average of five employees per firm. However, firms in the sample partially offset these cutbacks in origination and servicing personnel by increasing their staffs in other areas of their operations, possibly in wholesale and correspondent lending functions.

In addition to reducing staff, firms have been integrating new technologies into their operations. This is particularly evident in the servicing function where firms have increased their use of computer applications for collections and quality control. The result has been a substantial increase in productivity and a concomitant decline in servicing costs. Between the third quarters of 1988 and 1989, the number of loans serviced per servicing employee rose 12 percent, or 86 loans, to 789. In turn, direct servicing costs per single-family loan serviced declined 16 percent over the course of the year to an annualized rate of $60.52. Data processing costs associated with servicing also fell over the course of the year, dropping 17 percent per loan serviced to an annualized rate of $9.04 in the third quarter of 1989.

Mortgage Banking Industry Quarterly Cost, Productivity and Profitability Ratios (11 Firms)

	Third Quarter 1988	Third Quarter 1989	Percent Change
Cost Measures:			
Employment Cost Per Employee*	$31,684	$35,384	12%
Direct Cost of Servicing Single-Family Loan*	$ 72.12	$ 60.54	-16%
Direct Cost of Originating Single-Family Loan	$ 1,465	$ 1,469	0%
Productivity Measures:			
Single-Family Loans Serviced Per Servicing Employee	703	789	12%
Single-Family Loans Originated Per Origination Employee*	28	38	36%
Profitability Measures:			
Return on Average Equity*	6.84%	12.68%	85.4%
Return on Average Assets*	1.04%	1.76%	69.2%

*Annual Rate

Origination productivity also significantly increased over the period. The decline in origination staff, combined with a nearly 10 percent increase in the number of single-family loans closed, resulted in a 36 percent jump in the number of single-family loans closed per origination employee to 38 loans. Surprisingly, despite this significant jump in origination productivity, the direct origination cost per single-family loan closed was essentially unchanged from the previous year, averaging $1,469 in the third quarter of 1989. Because personnel expenses account for roughly two-thirds of direct origination costs, this suggests that employment costs per origination employee rose quite a bit faster than did employment costs per all employees.

Despite the stickiness of origination costs, two key measures of profitability increased substantially over the year. Return on average equity rose 85.4 percent to an annual rate of 12.68 percent, and return on average assets increased by 69.2 percent to an annual rate of 1.76 percent. However, as we have seen several times in the past year, much of the increase was due to large sales of servicing. Nevertheless, even without servicing sales, the trend in profitability over the last year has been clearly upward.

Obviously, 11 firms do not constitute the entire mortgage banking industry. However, the performance of these firms is heartening. We expect to see further evidence such as this in the months ahead as the fundamentals for the current year seem to favor mortgage banking. After an uptick in rates early this year, we expect interest rates to decline somewhat this Spring, fostering a modest increase in originations. Moreover, servicing operations are unlikely to suffer from unfavorable economic developments as a slight increase in the unemployment rate will most likely be offset by further modest gains in home prices, boosting homeowners' equity.

Does this mean that the worst is over for mortgage bankers? Maybe, although at this point it is difficult to say with certainty. But things do look better than they did in 1987.

Data from the RAS is quite useful in tracking current developments in the mortgage banking industry. Additional member firms that would like to participate in the quarterly survey are welcome. Reporting is relatively easy, and the results are routinely distributed shortly after the end of each quarter via the ECHO system or in a typed report. For further information, contact Rick Murray, programmer/analyst, MBA economics department, at (202) 861-1941.

Michelle V. Campbell
Economist

VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1989	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
OCT	9.84%	10.37%	9.52%	8.01%	8.30%	9.81%	8.62%	9.95%
NOV	9.71	10.36	9.39	7.99	8.13	9.67	8.51	9.77
DEC	9.70	10.20	9.25	NA	8.00	9.67	8.39	9.74
1990 JAN	**NA**	**NA**	**NA**	**NA**	**8.20**	**9.90**	**8.39**	**9.90**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
OCT	8.84%	8.53%	7.62%	7.99%	8.02%	8.01%	9.39
NOV	8.55	8.35	7.49	7.77	7.80	7.87	9.28
DEC	8.45	8.29	7.42	7.72	7.77	7.84	9.36
1990 JAN	**8.23**	**8.10**	**7.55**	**7.92**	**8.13**	**8.21**	**9.94**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
OCT	9.40%	9.42%	9.42%	139	141	141
NOV	9.26	9.31	9.31	139	144	144
DEC	9.26%	9.34%	9.32%	142	150	148
1990 JAN	**9.45**	**9.48**	**9.47**	**124**	**127**	**126**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1989	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
AUG	$2,842	$2,724	$203,923	$5,081	$7,851	$5,705	$7,283	$8,660	$6,161	$5,463
SEP	2,328	2,223	208,894	6,883	8,361	7,708	7,889	8,050	5,181	5,740
OCT	2,963	2,267	213,482	6,614	9,148	7,555	7,884	7,058	5,387	5,583
NOV	**2,536**	**2,376**	**220,118**	**8,720**	**8,112**	**10,948**	**7,653**	**7,059**	**4,408**	**5,823**
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,660	44,075	39,777	58,578	56,531
1987 TOTAL	25,415	20,531	---	63,230	68,210	76,615	76,840	75,018	116,611	96,983
11 MONTH AVG. 1989	2,265	1,776	---	5,421	6,848	7,131	6,352	5,902	4,474	4,747
1988	2,008	1,944	---	4,495	3,217	5,506	3,476	3,115	4,978	4,698
1987	2,027	1,526	---	5,169	6,008	6,999	6,689	6,529	10,270	8,390

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
SEP	1,264	1,028	236	1,319	1,012	307	161	248	486	369	170	254	509	386
OCT	1,423	1,083	340	1,356	1,025	331	173	285	567	398	172	276	492	416
NOV	1,342	1,050	292	1,342	1,043	299	180	297	488	377	171	275	496	400
DEC	**1,235**	**957**	**278**	**1,337**	**1,012**	**325**	**138**	**268**	**439**	**390**	**154**	**232**	**501**	**450**
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1987 TOTAL	1,621	1,212	409	1,535	1,114	421	269	298	634	420	272	282	575	406
12 MONTH AVG. (SAAR) 1989	1,385	1,064	321	1,339	1,013	326	184	272	536	393	181	258	505	395
1988	1,494	1,146	348	1,451	1,080	371	242	274	573	405	237	268	540	406
1987	1,634	1,223	412	1,543	1,122	421	273	309	631	422	275	289	571	406

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1989	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
SEP	3,520	2,320	7.9	640	364	7.1
OCT	3,480	2,170	7.5	637	364	7.0
NOV	3,590	2,420	8.1	696	365	6.4
DEC	**3,550**	**–**	**–**	**629**	**363**	**7.0**
1988 TOTAL	3,594	---	---	676	---	---
1987 TOTAL	3,526	---	---	671	---	---
12 MONTH AVG. (SAAR) 1989	3,446	---	---	654	---	---
1988	3,594	---	---	675	---	---
1987	3,526	---	---	671	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

Total[6]	1-Unit	2+ Units	Nonresidential
$274.5	$94.2	$19.0	$83.0
274.2	94.8	18.2	82.9
272.8	95.8	17.8	82.6
269.1	**96.5**	**17.4**	**79.2**
281.8	103.5	19.3	77.9
283.0	100.7	22.4	78.2
277.5	98.5	19.5	81.1
280.8	103.4	19.3	77.8
283.0	100.6	22.5	78.1

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED

By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 JUL	$26,320	$5,522	$11,109	$9,262	$85	$1,746	$296	$676	$471	$175	$17,380	$135	$852	$14,270	$1,996
AUG	32,360	6,150	14,708	11,627	121	2,611	329	939	960	258	14,354	269	1,054	10,628	2,342
SEP	32,249	5,592	13,689	12,396	110	2,503	678	860	495	290	12,206	226	880	8,176	2,727
OCT	**31,928**	**5,496**	**13,922**	**12,012**	**171**	**3,130**	**275**	**953**	**1,125**	**407**	**14,783**	**6**	**920**	**11,353**	**2,366**
1988 TOTAL	374,401	85,307	186,237	95,474	3,190	37,876	4,526	20,379	6,988	3,553	175,754	1,032	22,953	119,942	29,714
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
10 MONTH AVG. 1989	28,988	5,484	12,995	10,022	95	2,549	320	1,101	691	217	12,749	126	1,248	9,278	1,965
1988	31,426	7,342	15,503	7,980	252	2,996	352	1,632	546	283	14,432	79	1,907	10,154	2,102
1987	39,288	9,806	19,565	10,953	287	3,880	216	1,874	709	284	13,382	268	2,060	8,816	2,129

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 SEP	147	85	16	46	116	$8,981	68	$4,326	13	$1,033	35	$3,622
OCT	151	86	19	46	126	9,619	75	4,790	16	1,217	35	3,612
NOV	136	78	18	40	131	9,936	83	5,332	17	1,326	32	3,366
DEC	**116**	**62**	**16**	**38**	**102**	**7,971**	**55**	**3,542**	**15**	**1,193**	**32**	**3,236**
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1987 TOTAL	2,340	1,211	408	721	2,282	159,668	1,320	81,881	451	33,312	511	44,475
12 MONTH AVG. 1989	141	83	16	42	106	8,091	61	3,824	15	1,171	30	3,094
1988	147	70	18	50	112	8,196	58	3,548	18	1,314	35	3,305
1987	195	101	34	60	203	14,179	110	6,823	38	2,776	43	3,706

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

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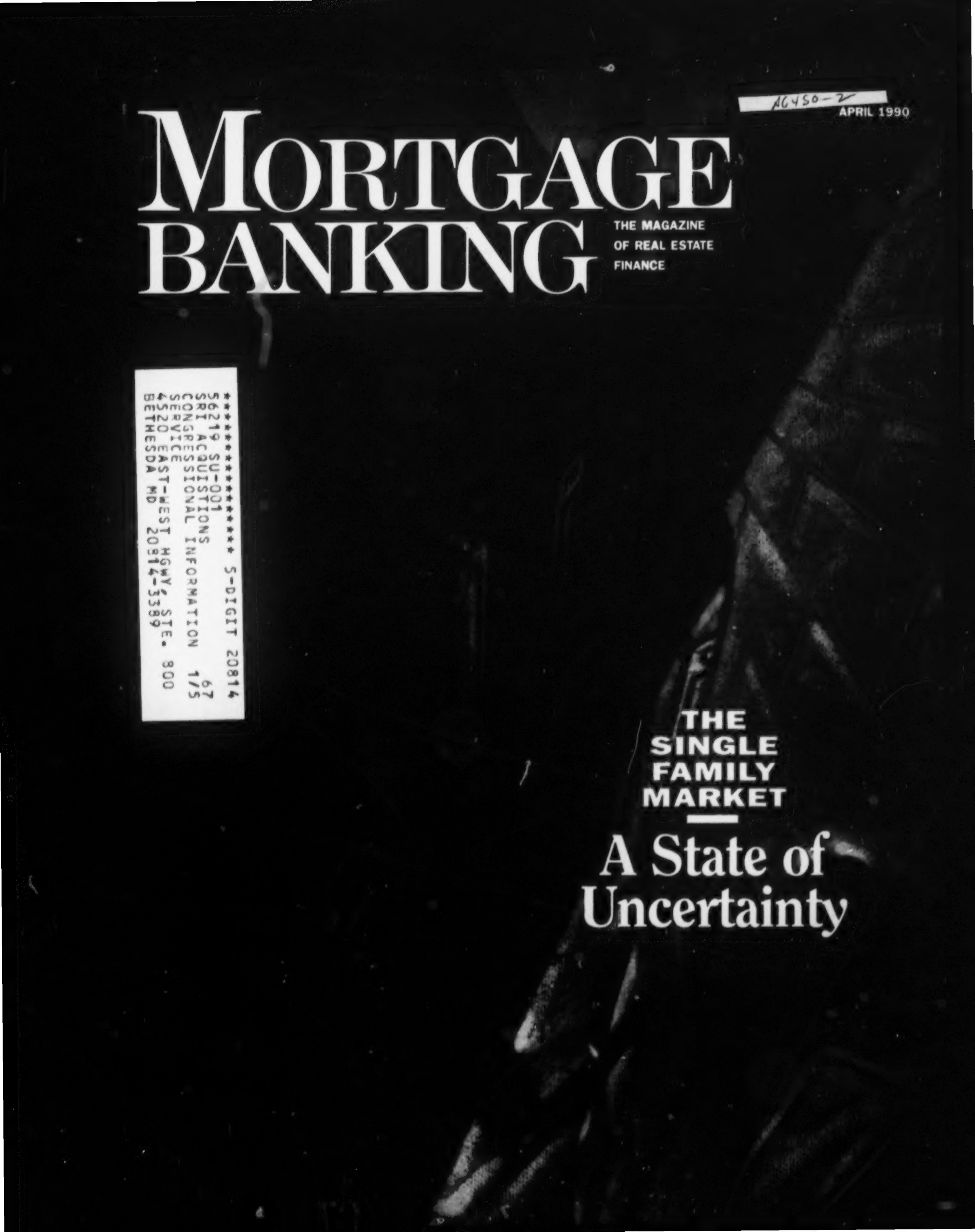

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THE SINGLE FAMILY MARKET

A State of Uncertainty

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COVER:
Single-family Housing

Different rules for different states. Lenders are seeing more and more of that as mortgage insurers, wholesalers, secondary market agencies and now even FHA are tailoring their underwriting rules to different state economies. Lenders who make loans in many states already are faced with tracking these many sets of changing rules. And the task is tough. If FHA moves toward regional underwriting, the problem will become even more widespread.

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COVER ILLUSTRATION BY ERIC WESTBROOK

PORTFOLIO

Complexity is thriving

Mortgage lenders crave uniformity. But that's less and less in the cards. Even the federal government mortgage insurance programs that used to foster uniformity are now moving in the opposite direction.

Our interview with FHA Commissioner Austin Fitts reveals that FHA is likely to move to some kind of regional underwriting approach in the near future. What this holds for each lending market is a mystery at this point. But Fitts says it means a loosening as well as a tightening where the economy justifies such moves.

This signals a departure for the government lending market, but it's something that has been a feature of the private mortgage insurance market and the giant secondary market agencies for a long time. To have FHA move to different credit standards for different regions marks the arrival of a new consciousness in federal government programs. It is being driven by the harsh economic reality that in America today, there can be a region in deep recession while neighboring regions are thriving.

The new consciousness at FHA also reflects the new thinking in Washington that is born and bred of the subsistence diet that all federal government programs have been put on because of the deep and lingering federal budget deficit. The thinking at HUD is FHA can't continue to take the kind of financial battering it's taking as a result of regional downturns that push tons of foreclosed properties into its inventory without having some kind of mechanism to respond to these downturns. The losses from FHA's property disposition efforts in such hard-hit regions are heavy and Fitts says the insurance funds cannot endure on a self-sustaining basis without changes to the overall "term and conditions" of the basic FHA insurance program. By this she means changes will be proposed to the down payment amounts, loan limits and premium structure for the FHA single-family program.

So, change appears inevitable. Keeping up with the changes that apply to each state market you lend in will be an ever-increasing challenge. Complexity rather than uniformity appears to be the new order of the day.

Janet Reilley Hewitt
Editor

COMING IN MAY

Some reports on how the secondary mortgage market is handling the great thrift asset sell-off and the outlook for the secondary market in general will be the focus next month. The issue will also examine the Community Reinvestment Act, HUD's reverse annuity mortgage program and the spread of employer-assisted housing programs.

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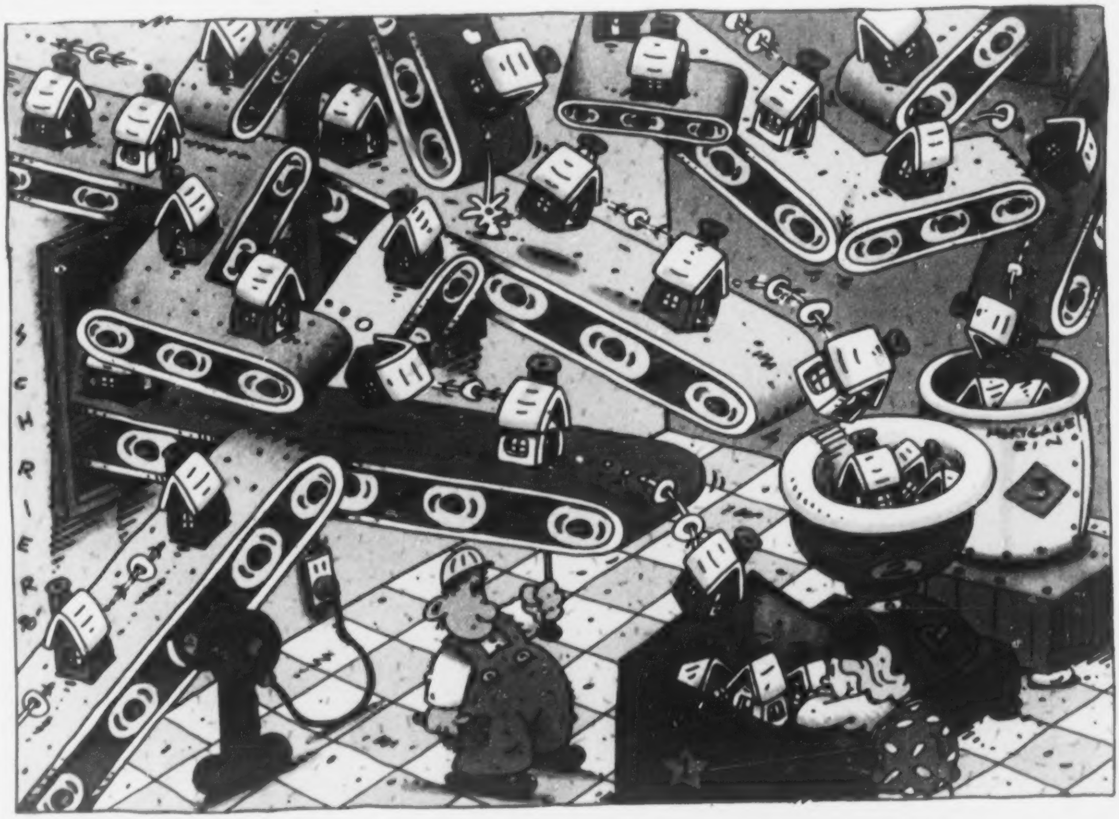
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MORTGAGE BIN

WHO'S WHO IN WHOLESALE

The big players are pulling in large amounts of new business.

• • •

Thomas S. LaMalfa

Wholesale mortgage banking is approaching adolescence and with minimal fanfare. So little, in fact, that our company, Asset Backed Capital Research, Inc. (ABCR) decided to create a monthly journal to chronicle the important developments and trends occurring within this somewhat neglected but booming sector of mortgage finance.

Wholesale mortgage banking, nonetheless, deserves recognition and will likely be among the few sectors of the mortgage market to flourish in the years ahead. The reasons for this are due to the new economics of mortgage banking. *Mortgage Banking* has reported extensively on the reasons behind this metamorphosis, so we will avoid a protracted discussion of the seemingly intractable forces now at work. Suffice it to say that industry segmentation, combined with cost pressures and the realization that the economies of scale in servicing, and the tax benefits derived from purchasing servicing, have altered the cost curve, thereby making wholesaling more profitable. At the same time, the old network of financial intermediaries is breaking down and being replaced by a new, lower cost structure in the primary market.

In this examination of the world of wholesaling, we will start with a few definitions so that we are in accord regarding terminology. Next, we will explore the rationale for this newest form of mortgage banking, discuss the various types of programs, and study the market's phenomenal growth.

The beginning

One of the major mortgage banking developments of the 1980s was the birth and growth of wholesale, or correspondent, mortgage banking. Not long ago, SMR Research, Budd Lake, New Jersey, aptly defined wholesale/correspondent mortgage banking as "a purchase, placement or referral transaction in which there is no direct contact with the borrower."

Wholesaling began in response to the need for alternative forms of gathering mortgages. New methods of generating business were made necessary by the stiff competition for and the high cost of direct mortgage originations. Innovative origination methods were deemed necessary in order to produce mortgage loans at the lowest possible cost, while simultaneously increasing revenue and income.

To accomplish this, mortgage lenders established programs to purchase loans from other originators. The programs borrow much of their structure from the models established by Fannie Mae and Freddie Mac, as well as from the private-sector conduits, such as Residential Funding Corporation, Bloomington, Minnesota, and Sears Mortgage Corporation, Riverwoods, Illinois.

Types of programs

There are four types of wholesale programs: broker, correspondent, bulk and servicing. Broker programs employ mortgage brokers to originate the mortgages. These originators take the applications and process the loans. But the loans are underwritten, closed and funded by the wholesaler, thus the wholesaler assumes the liability. A correspondent program differs from a broker program in that the originators are financial institutions, such as commercial banks, thrifts and mortgage companies. Under both broker and correspondent programs, loans are purchased on a loan-by-loan basis. Loans can also be purchased on a bulk basis in a correspondent program.

In a bulk-purchase program, the wholesaler buys a group or portfolio of closed mortgage loans. Bulk purchases are made on either a servicing-released or servicing-retained basis.

The final type of wholesale program is for the purchase of servicing. In a servicing transaction, the wholesaler purchases only the rights to service the loan, not the mortgage itself. (The wholesaler administers the borrower's monthly remittance and assumes complete responsibility for timely payment to the ultimate holder or investor of the loan or security.)

Countrywide Funding Corporation, Pasadena, California, for example, has both broker and correspondent programs. Countrywide refers to its broker program as its "wholesale" operation or division. By comparison, The Huntington Mortgage Company, Columbus, Ohio has only a correspondent program. Huntington does not deal with licensed mortgage brokers. The type of originator that a wholesaler does business with is the distinguishing characteristic between a broker and a correspondent program. Dollar Mortgage Corporation, LaMesa, California; Diamond Mortgage Corporation, Charlotte, North Carolina; and IMCO Realty Services, Santa Rosa, California, are examples of companies that deal almost exclusively with brokers. Who wholesalers do business with is largely determined by management and appears to be heavily influenced by the compa-

WHOLESALE MORTGAGE BANKING DESERVES RECOGNITION AND WILL LIKELY BE AMONG THE FEW SECTORS OF THE MORTGAGE MARKET TO FLOURISH IN THE YEARS AHEAD.

ILLUSTRATION BY FRED SCHRIER

ny's location.

In addition to these differences in type of originators and programs, products purchased also may vary. Some wholesalers purchase only government loans, others buy only conventionals. Still others buy both. What and how wholesalers buy, along with the services they provide the originator, is what differentiates one wholesaler from another.

Major players

This article will focus on some of the major players in the wholesale mortgage banking market. Exhibit 1 lists 58 of the wholesale lenders monitored by *Wholesale Access*, the monthly journal of wholesale mortgage banking. (Editor's note: *Mortgage Banking* wishes to clarify that the list of wholesalers tracked by *Wholesale Access* for the purpose of producing its rankings is not an all-inclusive one. There are other companies in the wholesale mortgage banking industry that are not included in the lists accompanying this article. At the time this article was written, the wholesalers tracked by *Wholesale Access* numbered 58. As of February, an additional 21 companies were added to the active wholesalers monitored by the publication.)

The data, which we compiled with the assistance of those surveyed, identifies the companies as well as their purchase volumes for 1988 and 1989, and lists their projections for 1990 purchases. Total volume rose from $28.5 billion in 1988 to $51 billion last year. In 1990, projected purchase volume is expected to total $62.2 billion. Note that six companies which were active in 1989 did not purchase loans at all in 1988. These new wholesalers included Covino & Co., Purchase, New York; Crestar Mortgage Corporation, Richmond, Virginia; Diamond Mortgage; NorthEastern Mortgage Company, Inc., Cambridge, Massachusetts; Republic Mortgage Services Company, Columbia, South Carolina; and United Mortgage Company, Denver.

Two major wholesalers, Lincoln Service Corporation, Owensboro, Kentucky, and Fireman's Fund Mortgage Corporation, Farmington Hills, Michigan, refused to disclose their purchases, as did several smaller companies, including N.A. Bancorp Mortgage, Inc., Covina, California; Kislak Mortgage Services Corpora-

EXHIBIT 1

Actual and Projected Purchase Volumes
(In millions of dollars)

Company	**1988**	**1989**	**1990p**
America's Mortgage Co.	$ 515	$ 1,450	$ 3,150
ARCS Mortgage, Inc.	30	160	250
Associates National Mortgage Corp.	1,600	1,200	1,700
BancBoston Mortgage Corp.	1,100	2,600	3,000
Boston Five Savings Bank	195	457	625
Caprock Mortgage Co.	95	265	575
Centerbank	52	61	90
CenTrust Mortgage	309	425	662
Chase Home Mortgage Corp.	554	1,040	1,210
Chemical Mortgage Co.	500	900	1,500
Citicorp Mortgage, Inc.	966	3,100	*
Commonwealth Mortgage Co.	220	495	700
Coreast Savings Bank	20	10	100
Countrywide Funding	2,020	2,060	2,000
Covino & Co.	0	58	250
Crestar Mortgage Corp.	0	60	180
Diamond Mortgage Corp.	0	105	125
Dominion Bankshares Mortgage Corp.	275	750	1,000
Empire of America Realty Credit Corp.	700	1,200	1,300
FBS Mortgage Corp.	650	800	800
First American Mortgage Corp.	74	181	310
First Federal S&L of Rochester	187	300	300
First National Mortgage Corp.	110	120	150
First Nationwide Bank	1,500	400	600
First NH Mortgage Corp.	160	365	450
First Union Mortgage Corp.	800	1,500	1,500
Fleet Mortgage Corporation	1,660	4,030	3,800
Fleet Real Estate Funding Corp.	1,400	2,550	3,500
Greentree Mortgage Corp.	300	450	550
Greenwich Capital Financial, Inc.	511	1,150	2,000
Gulf States Mortgage Co., Inc.	75	81	70
Hamilton Savings Bank	532	953	*
Home Owners Fed	375	1,200	1,600
Household Mortgage Services	650	1,600	2,100
The Huntington Mortgage Co.	157	325	600
Independence One Mortgage Corp.	165	775	1,200
Jersey Shore Savings & Loan Assoc.	26	85	200
Landmark Savings Association	98	160	400
The Leader Mortgage Co.	65	70	100
Marine Midland Mortgage Corp.	2,800	6,000	6,600
Merchants Mortgage Corp.	160	340	250
Metropolitan Financial Mortgage Corp.	115	131	153
North American Mortgage Co.	713	500	800
Northeastern Mortgage Co.	0	175	200
Norwest Mortgage, Inc.	1,000	1,700	3,000
Pacific First Mortgage	180	200	250
Prudential Home Mortgage Co.	2,080	2,618	4,200
Republic Mortgage Services Co.	0	350	1,080
Sears Mortgage Corp.	520	650	1,000
Security Pacific National Bank	200	500	650
Shawmut Mortgage Co.	205	225	225
Sovran Mortgage Corp.	236	460	700
Suncoast Funding Corp.	300	500	600
Talman Home Mortgage Corp.	39	105	150
Travelers Mortgage Services	682	2,300	3,300
TRUSTBANK Savings	270	332	300
United California Savings Bank	376	330	*
United Mortgage Co.	0	75	120
TOTAL	**$28,522**	**$50,982**	**$62,225**

* Not Disclosed

Source: Wholesale Access, February 1990

tion, Miami Lakes, Florida; Imperial Savings Association, San Diego; and Goldome Realty Credit Corp., Williamsville, New York. (Farragut Mortgage Co., Inc., Waltham, Massachusetts, is not listed because it was purchased by Huntington Mortgage late last year.) The figures include only whole loans purchased, either in bulk form or loan-by-loan, but not retail originations. Servicing transactions were also excluded from the purchase figures.

Exhibit 2 lists the top 25 wholesalers for 1988 in a ranking prepared by *Wholesale Access*. Combined, we calculated that they accounted for 86 percent of total wholesale purchases. Annual purchase volumes ranged from $309 million at CenTrust Mortgage Corporation, Deerfield Beach, Florida to $2.8 billion for Marine Midland Mortgage Corporation, Buffalo, New York. Three companies, Marine Midland Mortgage, Prudential Home Mortgage, Gaithersburg, Maryland, and Countrywide Funding, purchased in excess of $2 billion of mortgages and six others exceeded $1 billion.

There were about a dozen wholesalers who were active market participants in 1988 but who are not listed because they later ceased operations. Because their purchases are excluded, total activity is understated. This partially explains why volume rose so rapidly in 1989.

Large, fast-growing

Exhibit 3 provides *Wholesale Access'* ranking of 1989's 25 largest wholesalers. At least three new companies joined the ranks of the top 25: Independence One Mortgage Corporation, Southfield, Michigan; Dominion Bankshares Mortgage Corporation, McLean, Virginia; and Security Pacific National Bank, Cypress, California. Two others, First Nationwide Bank, San Francisco, and United California Savings Bank, Santa Ana, California, dropped out of the group. Annual purchase volumes ranged from a high of $6 billion at Marine Midland Mortgage to $500 million at North American Mortgage Company, Houston; Security Pacific National Bank; and Suncoast Funding Corporation, Methuen, Massachusetts. For this group, purchase activity totaled $42 billion, approximately $20 billion more than the aggregate from the top 25 in 1988.

EXHIBIT 2

Largest Purchase Volumes 1988
(In millions of dollars)

Company	
Marine Midland Mortgage Corp.	$2,800
Prudential Home Mortgage Co.	2,080
Countrywide Funding	2,020
Fleet Mortgage Corporation	1,660
Associates National Mortgage Corp.	1,600
First Nationwide Bank	1,500
Fleet Real Estate Funding Corp.	1,400
BancBoston Mortgage Corp.	1,100
Norwest Mortgage, Inc.	1,000
Citicorp Mortgage, Inc.	966
First Union Mortgage Corp.	800
North American Mortgage Co.	713
Empire of America Realty Credit Corp.	700
Travelers Mortgage Services	682
FBS Mortgage Corp.	650
Household Mortgage Services	650
Chase Home Mortgage Corp.	554
Hamilton Savings Bank	532
Sears Mortgage Corp.	520
America's Mortgage Co.	515
Greenwich Capital Financial, Inc.	511
Chemical Mortgage Co.	500
United California Savings Bank	376
Home Owners Fed	375
CenTrust Mortgage	309
TOTAL	**$24,513**

Source: *Wholesale Access*, February 1990

EXHIBIT 3

Purchase Volumes 1989
(In millions of dollars)

Company	
Marine Midland Mortgage Corp.	$6,000
Fleet Mortgage Corporation	4,030
Citicorp Mortgage, Inc.	3,100
Prudential Home Mortgage Co.	2,618
BancBoston Mortgage Corp.	2,600
Fleet Real Estate Funding Corp.	2,550
Travelers Mortgage Services	2,300
Countrywide Funding	2,060
Norwest Mortgage, Inc.	1,700
Household Mortgage Services	1,600
First Union Mortgage Corp.	1,500
America's Mortgage Co.	1,450
Associates National Mortgage Corp.	1,200
Empire of America Realty Credit Corp.	1,200
Home Owners Fed	1,200
Greenwich Capital Financial, Inc.	1,150
Chase Home Mortgage Corp.	1,040
Hamilton Savings Bank	953
Chemical Mortgage Co.	900
FBS Mortgage Corp.	800
Independence One Mortgage Corp.	775
Dominion Bankshares Mortgage Corp.	750
Sears Mortgage Corp.	650
North American Mortgage Co.	500
Security Pacific National Bank	500
Suncoast Funding Corp.	500
TOTAL	**$43,126**

Source: *Wholesale Access*, February 1990

EXHIBIT 4

Fastest Growing Wholesalers 1989
(In millions of dollars)

Company	1988	1989	% change over 1988
ARCS Mortgage, Inc.	$ 30	160	433.3
Independence One Mortgage Corp.	165	775	369.7
Travelers Mortgage Services	682	2,300	237.2
Jersey Shore Savings & Loan Assoc.	26	85	226.9
Citicorp Mortgage, Inc.	966	3,100	220.9
Home Owners Fed	375	1,200	220.0
America's Mortgage Co.	515	1,450	181.6
Caprock Mortgage Co.	95	265	178.9
Dominion Bankshares Mortgage Corp.	275	750	172.7
Security Pacific National Bank	200	500	150.0
Household Mortgage Services	650	1,600	146.2
First American Mortgage Corp.	74	181	144.6
Fleet Mortgage Corp.	1,660	4,030	142.8
BancBoston Mortgage Corp.	1,100	2,600	136.4
Boston Five Savings Bank	195	457	134.4
First NH Mortgage Corp.	160	365	128.1
Greenwich Capital Financial, Inc.	511	1,150	125.0
Commonwealth Mortgage Co.	220	495	125.0
Marine Midland Mortgage Corp.	2,800	6,000	114.3
Merchants Mortgage Corp.	160	340	112.5
The Huntington Mortgage Co.	157	325	107.0
Sovran Mortgage Corp.	236	460	94.9
Chase Home Mortgage Corp.	554	1,040	87.7
First Union Mortgage Corp.	800	1,500	87.5
TOTAL	**$12,606**	**$31,128**	**146.9**

Source: *Wholesale Access*, February 1990

Seventeen companies, according to our data, purchased $1 billion or more in mortgage loans compared with eight, one year earlier. In 1989, 13 of the companies buying $500 million or more were owned by commercial banks, three were owned by insurance companies, five had thrift institution parents, and five had parent companies that were neither banks, insurance companies or thrifts.

Exhibit 4 lists the 25 fastest growing companies identified by *Wholesale Access* based on increased wholesale activity from 1988 to 1989. Among these lenders, increases in purchases ranged from 87.5 percent at First Union Mortgage Corporation, Charlotte, North Carolina, to 433.3 percent at ARCS Mortgage Inc., Calabasas, California. Eleven companies we followed increased their activity by 150 percent or more. Four of the fastest growing companies did so from extremely small bases; their purchase volumes totaled $200 million or less in the prior year.

THE OLD NETWORK OF FINANCIAL INTERMEDIARIES IS BREAKING DOWN AND BEING REPLACED BY A NEW, LOWER COST STRUCTURE IN THE PRIMARY MARKET.

Exhibit 5 shows the top 25 wholesalers according to *Wholesale Access'* ranking based on activity levels anticipated for 1990. (The three companies with asterisks by their names established purchase ranges. In all instances, we cited the high-end of the projected range.) To be among those companies listed, projections for purchase volume would have to exceed $700 million. Indeed, all but four of the companies on the list expect to do $1 billion or more in business. Eleven of the companies forecast volume of at least $2 billion. The top 25 project total purchases of $52.7 billion, 85 percent of the $62.2 billion projected by all wholesalers we identified for 1990. Two of the companies listed in this exhibit, Fleet Mortgage Corporation, Milwaukee, Wisconsin, and Countrywide Funding, anticipate modest rollbacks in activity compared with 1989. Two others, First Union Mortgage and FBS Mortgage Corporation, St. Paul, Minnesota, project no change in their level of activity.

Of the 21 companies on the ranking that anticipate growth, individual percentages of growth range from a low of 8.3 percent at Empire of America Realty Credit Corp., Buffalo, New York, to a high of 208.6 percent at Republic Mortgage Services. America's Mortgage Company, Springfield, Illinois, is the only company in addition to Republic that expects to double volume from the prior year's level.

Exhibit 6 lists the 22 companies identified by *Wholesale Access* that expect to increase volume in 1990 from the previous year by 50 percent or more. Except for America's Mortgage, all of the other seven companies looking to increase volume two-fold or better are relatively small companies. However, six of the remaining fourteen companies project purchase volumes of 50 percent or greater than 1989 levels. These companies are Prudential Home Mortgage, Norwest Mortgage Co., Inc., Flanders, New Jersey; Greenwich Capital Financial Inc., Irving, Texas; Chemical Mortgage Company, Columbus, Ohio; Independence One Mortgage and Sears Mortgage.

EXHIBIT 5

Projected Volumes 1990
(in millions of dollars)

Company	**1990**	**% change over/(under) 1989**
*Marine Midland Mortgage Corp.	$ 6,600	10.0
*Prudential Home Mortgage Co.	4,200	60.4
Fleet Mortgage Corporation	3,800	(5.7)
Fleet Real Estate Funding Corp.	3,500	37.3
Travelers Mortgage Services	3,300	43.5
America's Mortgage Co.	3,150	117.2
BancBoston Mortgage Corp.	3,000	15.4
Norwest Mortgage, Inc.	3,000	76.5
Household Mortgage Services	2,100	31.3
Countrywide Funding	2,000	(2.9)
Greenwich Capital Financial, Inc.	2,000	73.9
Associates National Mortgage Corp.	1,700	41.7
Home Owners Fed	1,600	33.3
Chemical Mortgage Co.	1,500	66.7
First Union Mortgage Corp.	1,500	0.0
Empire of America Realty Credit Corp.	1,300	8.3
Chase Home Mortgage Corp.	1,210	16.3
Independence One Mortgage Corp.	1,200	54.8
Republic Mortgage Services Co.	1,080	208.6
Dominion Bankshares Mortgage Corp.	1,000	33.3
Sears Mortgage Corp.	1,000	53.8
FBS Mortgage Corp.	800	0.0
North American Mortgage Co.	800	60.0
*Commonwealth Mortgage Co.	700	41.4
Sovran Mortgage Corp.	700	52.2
TOTAL	**$52,740**	**32.3**

Source: *Wholesale Access*, February 1990

EXHIBIT 6

Fastest Growing Companies Based on Projected Growth

Company	**% change over 1989**
Coreast Savings Bank	900.0
Covino & Co.	331.0
Republic Mortgage Services Co.	208.6
Crestar Mortgage Corp.	200.0
Landmark Savings Association	150.0
Jersey Shore Savings & Loan Assoc.	135.3
America's Mortgage Co.	117.2
Caprock Mortgage Co.	117.0
The Huntington Mortgage Co.	84.6
Norwest Mortgage, Inc.	76.5
Greenwich Capital Financial, Inc.	73.9
First American Mortgage Corp.	71.3
Chemical Mortgage Co.	66.7
Prudential Home Mortgage Co.	60.4
North American Mortgage Co.	60.0
United Mortgage Co.	60.0
ARCS Mortgage, Inc.	56.2
CenTrust Mortgage	55.8
Independence One Mortgage Corp.	54.8
Sears Mortgage Corp.	53.8
Sovran Mortgage Corp.	52.2
First Nationwide Bank	50.0
TOTAL	**79.3**

Source: *Wholesale Access*, February 1990

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Growth of market

As the aggregate data indicates, wholesale activity increased nearly 80 percent in 1989 compared with 1988. Current projections suggest market participants anticipate an additional 22 percent increase during 1990. At $51 billion plus, wholesale production accounted for approximately 18.5 percent of all first mortgage loans originated in 1989.

One must ask why the wholesale market is growing so quickly. Certainly, other investor arenas, such as the agency market, are not expanding anywhere near as rapidly.

Reasons for growth

Phenomenal growth of wholesale activity in recent years is due to eight factors. The growth is occurring primarily because wholesale production:

- Supplements retail originations by leveling out the production flow in the back office;
- Aids lenders in building large servicing portfolios quickly;
- Decreases the geographic concentration that results from the local and branch locations most lenders have in place;
- Allows for sufficient production volumes so that hedging and secondary market sales become more cost efficient;
- Does not require large, new fixed expenditures to be incurred for personnel or branches;
- Allows lenders to take advantage of accounting and regulatory changes, such as FASB 65, FASB 91 and the new risk-based capital requirements that favor wholesale lending;
- Allows lenders to take advantage of structural changes in the mortgage market, such as industry consolidation and the advent of the extensive, new broker/originator market; and
- Provides what many view as a less costly, more efficient means of producing mortgages.

Wholesale production's many benefits will allow it to continue flourishing through its adolescence. The new economics of mortgage banking are likely to keep this industry segment thriving into a full and prosperous adulthood. **MB**

Thomas S. LaMalfa is president of Asset Backed Capital Research, Inc., Cleveland.

ECONOMIC TRENDS

Affordability problems arise from a variety of sources. Inadequate income levels and growth, high interest rates, and large down payment requirements are among the most important, but high home prices and rapid home price appreciation are also to blame.

The role of new home construction is particularly important. Today's new home construction constitutes part of tomorrow's national housing stock. Consequently, both the characteristics of new homes and their prices can have important long-run effects on affordability.

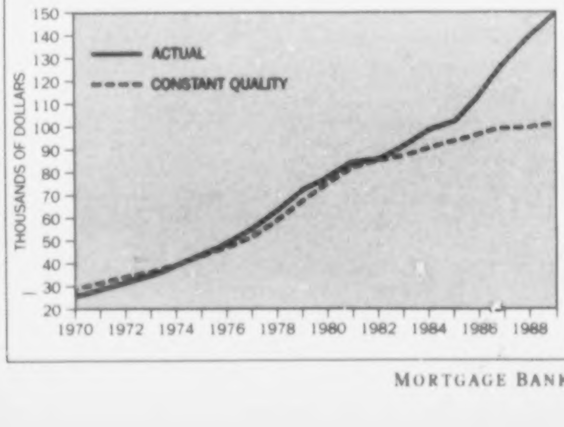
New home prices and their characteristics, like nearly every other aspect of housing market activity in the past 25 years, has been strongly influenced by the baby boom generation. During the 1970s, the maturation of the baby boomers—those individuals born from 1946 to 1964—led to an explosive increase in the number of new household formations and a concomitant surge in the demand for housing. Supply met this demand, but not without a sharp rise in prices. New home prices increased at an 11.1 percent annual rate from 1970 to 1980. Higher overall inflation rates, interest rates that in some years were less than the inflation rate, and expectations of sharply higher home prices in the future also contributed to the rise in prices.

In the 1980s, however, new household formations slowed significantly as the baby boomers continued to age and many had already formed their households. At the same time, the inflation rate decelerated sharply and was relatively subdued during most of the decade. Yet, new home prices still rose at nearly an 8 percent annual rate.

TABLE 1. Characteristics of New Homes Sold

	Percentage of New Homes with the Characteristic			
Characteristic	**1980**	**1985**	**1987**	**1989**
Central air conditioning	63	70	71	76
2½ bathrooms or more	25	29	38	44
4 bedrooms or more	20	18	23	28
1 fireplace or more	56	59	62	65
Garage for 2 cars or more	56	55	65	70
Addendum:				
Average size (square feet)	1,740	1,785	1,905	2,035

CHART 1 Average New Home Prices



What accounts for continued rapid increases in new home prices even with such a sharp change in some of the most important fundamentals? Part of the answer clearly rests on the significant changes in the characteristics of new homes built during the 1980s. During the course of the decade, larger new homes were being constructed with more amenities. The baby boomers probably had a lot to do with the trend. It is true that many baby boomers were squeezed out of homeownership by affordability problems, but many others did become homeowners during the 1970s and enjoyed significant equity growth in their starter homes. During the 1980s, many of these households entered the move-up market, and the type of home they wanted to purchase (and could purchase due to their earlier gains and, often, rapidly increasing two-earner incomes) were larger and had more amenities.

Recently released data on the characteristics of new homes sold through 1989 dramatically illustrate the trends (Table 1). In 1980, the average square footage of new homes was 1,740 square feet; by 1989, for the first time ever, it had risen to more than 2,000 square feet. During the same period, the percentage of homes with two and a half bathrooms or more approximately doubled, while the share with four bedrooms or more rose 8 percentage points, the share with one fireplace or more rose 9 percentage points, and the share with garages for two or more cars jumped 14 percentage points.

To gauge the importance of these added features to rising home prices, the Census Bureau estimates the price of a hypothetical "constant quality" home that has the characteristics of a home built in 1982. Because the features are held constant, it is possible to see how much prices would have changed without additional amenities and how much those amenities contributed to the price increases.

Chart 1 shows actual and constant quality new home prices from 1970 to 1989. During the 1970s, both measures rose rapidly due to the fundamentals discussed earlier, but added amenities did little to boost prices. However, in the 1980s, constant-quality prices rose much less rapidly than actual prices, with the gap between the two measures reflecting how much added amenities contributed to price increases. At an annual rate, constant-quality prices rose just 3.4 percent during the decade.

Will added amenities continue to contribute to increases in new home prices? Probably. As the baby boomers continue to move through the age distribution of the population, their preferences for larger homes with more amenities are likely to persist, and so the housing stock will increasingly consist of larger and more expensive units. This will continue to be an important contributor to affordability problems for first-time homebuyers and, particularly, for those at the lower end of the income scale.

Thomas M. Holloway
Senior Economist

VITAL STATISTICS

INTEREST RATES & YIELDS

1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHLBB			FNMA		FHLMC	
1989	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
NOV	9.71%	10.36%	9.39%	7.99%	8.13%	9.67%	8.51%	9.77%
DEC	9.70	10.20	9.25	7.92	8.00	9.67	8.39	9.74
1990								
JAN	9.87	10.12	9.34	NA	8.18	9.90	8.41	10.05
FEB	**NA**	**NA**	**NA**	**NA**	**8.30**	**10.11**	**8.44**	**10.31**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1989	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
NOV	8.55%	8.35%	7.49%	7.77%	7.80%	7.87%	9.28%
DEC	8.45	8.29	7.42	7.72	7.77	7.84	9.36
1990							
JAN	8.23	8.10	7.55	7.92	8.13	8.21	9.63
FEB	**8.24**	**8.14**	**7.70**	**8.11**	**8.39**	**8.47**	**9.84**

CURRENT SECONDARY MARKET YIELDS

SPREADS

(Basis Points)

1989	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
NOV	9.26%	9.31%	9.31%	139	144	144
DEC	9.26	9.34	9.32	142	150	148
1990						
JAN	9.45	9.48	9.47	124	127	126
FEB	**9.64**	**9.63**	**9.63**	**117**	**116**	**116**

SECONDARY MARKET ACTIVITY

(Dollars in Millions)

	FNMA				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1989	Commitments	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
OCT	$2,963	$2,267	$213,482	$6,614	$9,148	$7,555	$7,884	$7,058	$5,387	$5,583
NOV	2,336	2,376	220,118	8,720	8,112	10,948	7,653	7,059	4,408	5,823
DEC	2,495	2,982	228,232	10,136	10,084	7,820	8,718	8,526	10,934	5,305
1990										
JAN	**1,787**	**2,214**	**233,903**	**7,760**	**NA**	**NA**	**NA**	**NA**	**5,032**	**5,249**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,447	60,149	57,522
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
1 MONTH AVG.										
1990	1,787	2,214	---	7,760	NA	NA	NA	NA	5,032	5,249
1989	1,087	1,037	---	4,074	3,492	5,206	3,586	3,408	4,830	4,584
1988	2,254	1,267	---	1,683	2,255	3,037	2,168	1,832	1,651	4,348

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1989	**Total**	**1-4 Units**	**5+ Units**	**Total**	**1-4 Units**	**5+ Units**	**Northeast**	**Midwest**	**South**	**West**	**Northeast**	**Midwest**	**South**	**West**
OCT	1,423	1,083	340	1,356	1,025	331	174	285	567	397	172	276	492	416
NOV	1,347	1,050	290	1,342	1,043	299	179	296	498	374	171	275	496	400
DEC	1,254	966	288	1,376	1,035	341	140	272	427	415	168	241	501	466
1990 JAN	**1,625**	**1,191**	**434**	**1,743**	**1,092**	**651**	**194**	**388**	**532**	**511**	**185**	**475**	**636**	**447**
1989 TOTAL	1,374	1,057	317	1,341	1,008	333	179	266	536	394	182	256	504	399
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
1 MONTH AVG. (SAAR) 1990	1,625	1,191	434	1,743	1,092	651	194	388	532	511	185	475	636	447
1989	1,659	1,254	405	1,486	1,127	359	288	304	639	428	229	290	563	404
1988	1,339	1,037	302	1,264	985	279	292	212	459	376	259	228	427	350

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1989	**Sold (SAAR)**	**Available for Sale**	**Months Supply At Current Sales Rate**	**Sold (SAAR)**	**Available for Sale**	**Months Supply At Current Sales Rate**
OCT	3,490	2,170	7.5	636	363	7.0
NOV	3,560	2,420	8.1	692	363	6.5
DEC	3,560	1,860	6.3	634	361	7.0
1990 JAN	**3,480**	**NA**	**NA**	**589**	**365**	**7.3**
1989 TOTAL	3,440	---	---	650	---	---
1988 TOTAL	3,594	---	---	676	---	---
1 MONTH AVG. (SAAR) 1990	3,480	---	---	589	---	---
1989	3,660	---	---	704	---	---
1988	3,200	---	---	574	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1982 Dollars, Seasonally Adjusted Annual Rates)

Total[6]	**1–Unit**	**2+ Units**	**Nonresidential**
$274.2	$94.8	$18.2	$82.9
272.2	96.0	17.8	82.9
267.6	96.8	17.2	78.0
276.9	**99.5**	**17.2**	**82.5**
276.3	98.0	19.3	81.0
284.5	102.9	19.7	81.2
276.9	99.5	17.2	82.5
286.2	106.4	19.4	82.5
280.4	101.3	21.2	79.5

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 AUG	$32,336	$6,150	$14,078	$11,603	$121	$2,537	$329	$939	$884	$258	$14,179	$269	$1,054	$10,453	$2,342
SEP	32,284	5,592	13,689	12,431	110	2,460	678	860	451	290	12,069	226	880	8,039	2,727
OCT	31,921	5,496	13,922	12,005	171	3,038	275	953	1,133	407	14,587	6	920	11,157	2,366
NOV	**29,197**	**5,212**	**12,952**	**10,533**	**171**	**3,006**	**650**	**862**	**983**	**280**	**15,036**	**416**	**843**	**10,924**	**2,777**
1988 TOTAL	383,820	85,307	189,125	101,863	3,331	38,198	4,526	20,591	6,920	3,732	181,372	1,032	24,136	124,106	29,986
1987 TOTAL	449,544	110,093	208,054	124,551	3,209	44,981	2,409	22,492	8,299	3,547	168,652	2,871	25,613	110,490	28,160
11 MONTH AVG. 1989	29,006	5,459	12,991	10,067	102	2,568	350	1,080	694	223	12,890	152	1,211	9,361	2,036
1988	31,983	7,168	15,708	8,498	261	3,056	375	1,661	547	282	14,602	73	1,997	10,157	2,192
1987	38,188	9,410	17,604	10,596	281	3,774	210	1,836	697	293	13,496	251	2,047	8,888	2,200

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1989 OCT	151	86	19	46	126	$9,619	75	$4,790	16	$1,217	35	$3,612
NOV	136	78	18	40	131	10,024	83	5,332	17	1,326	32	3,366
DEC	116	62	16	38	102	7,971	55	3,542	15	1,193	32	3,236
1990 JAN	**127**	**77**	**18**	**32**	**118**	**9,041**	**70**	**4,428**	**18**	**1,405**	**30**	**3,208**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
1 MONTH AVG. 1990	127	77	18	32	118	9,041	70	4,428	18	1,405	30	3,208
1989	105	59	16	30	121	8,652	76	4,629	17	1,240	28	2,783
1988	110	58	14	38	120	8,246	74	4,453	16	1,143	30	2,650

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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MAY 1990

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Adapting to a New Environment

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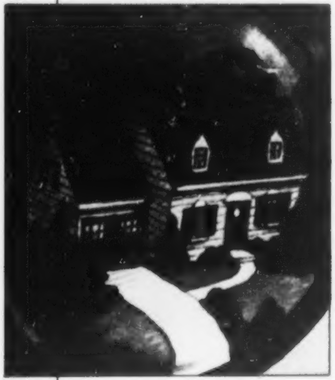
Secondary Mortgage Market



The closing of the decade caught the secondary markets in the midst of visible change. Today's sellers of mortgage-backed securities were yesterday's major buyers. These new-found sellers—thrifts in search of regulatory capital—dropped their MBS holdings by $50 billion in 1989 by Moody's count. Commercial banks are wearing new colors too as heavy buyers of mortgage securities. While on the CMO front, the agencies leapfrogged all other issuers last year to claim an 85 percent market stake versus 34 percent in 1989. All in all, it's a changed environment.

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COVER ILLUSTRATION BY JEANNE TURNER

Secondary Tremblers

The secondary market was hit by powerful external forces last year. The result was huge shifts—both up and down—in the numbers that serve as a proxy for the market's activity.

The Richter scale registered some big surges in volume—whole loan CMOs for example tripled in volume last year. On the downward slope, senior/subs tumbled by 40 percent at last year's final quarter compared with their dominant presence in pass-through deals in 1988.

Even a real quake rocked the secondary in October. San Mateo-based Bay View Federal Savings & Loan Association had its triple-A rated, commercial mortgage-backed securities placed on a watchlist by Moody's for possible downgrade. The damage to collateral from the "act of God" was deemed insignificant by Moody's and the rating was reaffirmed.

But a real fundamental shifting of the foundation of the secondary market contributed to the controlled upheaval that shook the MBS markets last year. On top of an actual quake of major proportions, a symbolic quake rocked Wall Street when a major brokerage firm, with substantial mortgage securities dealings, went under. The fall of Drexel clinched these times as uniquely risky and prone to precipitous shifts in fortune.

A quick look at some numbers tells at least part of the story. The combined, single-class MBS issuance out of GNMA, Fannie Mae and Freddie Mac rose $50 billion last year versus 1988. That was a jump of 33 percent. Ninety-eight percent of that came from Fannie Mae and Freddie Mac. So, clearly the agencies benefited from the change rumbling through the market. Some big buyers of those conventional MBS were banks. In 1989's third quarter alone, banks boosted their holdings of MBS by 20.4 percent, HUD says. Risk-based capital rules proved a major force driving securitization volume. However, two apparent losers in the MBS market last year were U.S. investment banks and the U.K. secondary market, by Moody's reckoning anyway. CMO issuance by investment banks dropped by 69 percent last year versus 1988 volume. And mortgage-backed notes posted a zero growth year in the U.K. largely due to depressed originations tied to high interest rates. Looking ahead, this year will be hard pressed to measure up.

Janet Reilley Hewitt
Editor in Chief

Coming in June

An eye-opener on foreclosure and delinquency trends will be the lead piece in the June servicing issue. For those of you who think current problem loan rates are incredibly high compared to historical norms—you're right. Our lead story tells us that the number of loans in foreclosure rose 590 percent from 1965 to 1989.

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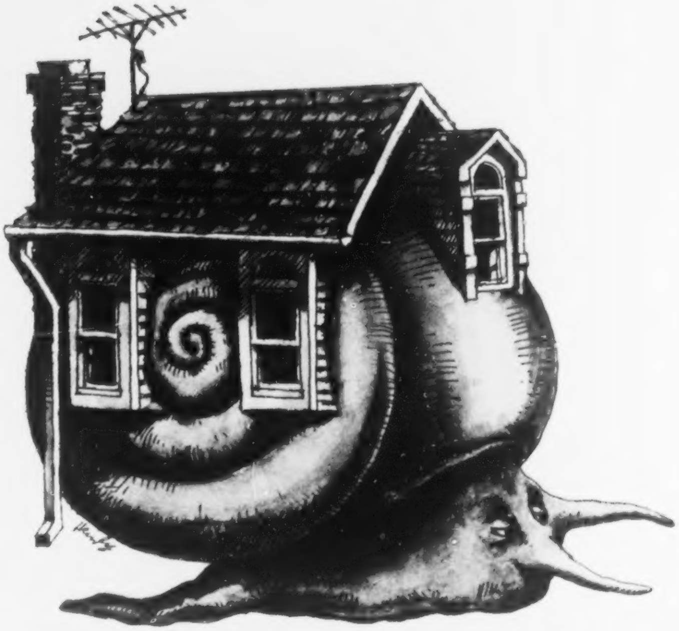
Mortgage Prepayments Slow to a Crawl

Steadily declining prepayments are likely to continue at a snail's pace as a fall off in first-time homebuyers begins to take hold.



Prepayment rates of Freddie Mac and Fannie Mae pass-throughs have declined steadily since 1986, because of diminished housing demand, reduced home price inflation and weakening demographics. Pools backed by conventional mortgages originated since 1985 are paying down even more slowly than those made up of older loans written in the 1970s. We expect that a falloff in the number of first-time homebuyers will accentuate the slowing prepayment trend in the 1990s.

The mortgage securities market, however, has not fully adjusted to this prepayment shift—the prices of many sectors still reflect the faster prepayments seen a few years ago.

Prepayment rates since 1986 are summarized in Figure 1. They are expressed as percentages of the Public Securities Association standard prepayment model (PSA), for "old" Freddie Mac and Fannie Mae 8s, 9s and 10s. These pools have remaining weighted-average maturities (WAMs) of 22 years or less and are made up of conventional mortgages originated in the 1970s. The prepayment rates of these older pass-throughs have fallen steadily during the 1986-89 period. Prepayment rates of the other coupons have declined comparably.

Rising interest rates since 1987 account for some of the slowdown in these prepayment rates. However, the magnitude of the fall off cannot be explained by interest rate movements alone. Even adjusting for interest rate levels, prepayment rates of these securities have slowed steadily since 1986. (We focus in this report on the decline of Freddie Mac/Fannie Mae prepayment rates. GNMA prepayments also have slowed during the past few years, but to a much smaller degree. We can speculate that shifts in the economic forces fueling housing activity, such as reduced home price inflation, have less impact on moderate income FHA/VA borrowers than they do on conventional mortgage borrowers.)

Moderately seasoned securities

The interest rate path of the past decade created two distinct segments of 8 percent to 10 percent mortgage pass-through securities: those backed by loans originated in the 1970s, and those made up of loans written since 1985.

As illustrated in Figure 2, the amount outstanding of the newer issues has grown rapidly and now exceeds that of older pass-throughs. "Moderately seasoned pass-throughs"—those issued since 1985 that are now at least two years-old—also now surpass in volume the amount of older pools.

As shown in Figure 3, the moderately seasoned pass-throughs are paying off even more slowly than the older securities. During the past two years, the prepayment rates of moderately seasoned Freddie Mac/Fannie Mae 8s, 9s and 10s have been 9 percent to 37 percent PSA slower than those of their older counterparts. Moderately seasoned 9s, for instance, prepaid at only

ILLUSTRATION BY JOHN HEINLY

Ravi Mattu, Mark Gordon and Michael Waldman

126 percent PSA during 1988 and 1989, compared with 163 percent PSA and 145 percent PSA for old 9s. These differences, however, appear to be narrowing with time. Based on recent prepayment experience, our projections for the moderately seasoned securities are about 20 percent PSA slower than for the old pass-throughs.

The slower prepayments of the moderately seasoned issues are of special significance because these securities represent the majority of the seasoned pass-throughs that are traded. Furthermore, moderately seasoned pass-throughs back essentially all interest-only and principal-only STRIPs collateralized by conventional mortgages.

Several factors have led to the slowdown in prepayments since 1986. The pent-up demand for housing caused by the high interest rate environment of the early 1980s was substantially satisfied during the 1984-1987 period. Because of high mortgage rates, housing starts plunged from an annual rate of 2 million units in 1978 to 1.1 million units in 1982. As mortgage rates subsequently declined, housing starts recovered and averaged 1.7 million units during the 1984-1987 period, before gradually falling to an estimated level of 1.4 million units in 1989.

Slower home price appreciation has reduced housing market activity—homeowners are less eager to trade up to larger homes if they do not expect to realize profits on their housing investments. The average price of existing homes sold increased by only 4.3 percent in 1989, after rising at annual rates of 6.3 percent in 1986-87 and 9.9 percent during the 1970s, according to the National Association of Realtors. Soft housing prices in many markets nationwide at present will further deter activity.

The prepayment difference between old and moderately seasoned pass-throughs is partly explained by the impact of ARM financing. Homeowners who are relatively mobile were attracted to ARMs in large numbers beginning in 1982. The corresponding population of fixed-rate mortgage borrowers has been less likely to move, and mortgages of these homeowners have exhibited slower prepayments. This phenomenon should not affect the prepayments of the older mortgages, which were originated before the advent of the ARMs market.

Another reason for the difference is the greater accumulated equity in the homes that were purchased in the 1970s, compared with those bought since 1985. Equity buildup promotes mortgage turnover by providing down payments for new home purchases and by enabling prepayments for cash take out refinancings.

FIGURE 1

PSA Prepayment Rates of Old Freddie Mac/Fannie Mae Pass-Throughs, 1986-89[a]

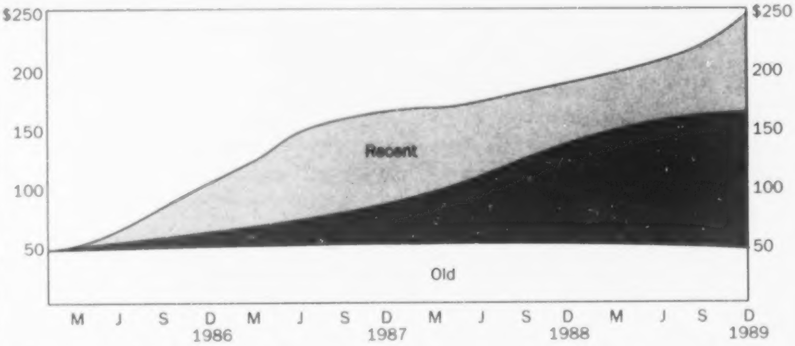
Year	Average Current-Coupon FHLMC Yield[b]	Coupon 8%	9%	10%
1986	10.19%	160%	192%	265%
1987	9.39	169	210	340
1988	10.17	134	163	208
1989	10.32	119	145	177

[a] Thirty-year conventional mortgage pools with current WAMs of 22 years or less.

[b] Lagged three months.

Figure 2

Freddie Mac/Fannie Mae 8%-10% Pass-throughs Outstanding 1986-89 (Dollars in Billions)[a]



[a] Thirty-year conventional mortgage pools.
Recent: WAM between 28 years and 30 years.
Mod. Seasoned: WAM between 22 years and 28 years.
Old: WAM less than 22 years.

FIGURE 3

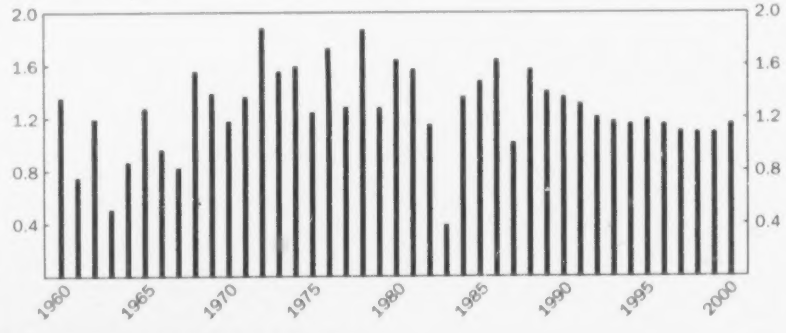
PSA Prepayment Rates of Old and Moderately Seasoned Freddie Mac/Fannie Mae Pass-Throughs

	8%			9%			10%		
Year	Old	Mod. Seas.	Diff.	Old	Mod. Seas.	Diff.	Old	Mod. Seas.	Diff.
1987	169%	112%	57%	210%	113%	97%	340%	312%	28%
1988	134	112	22	163	126	37	208	179	29
1989	119	110	9	145	126	19	177	152	25

Old: WAM less than 22 years.
Mod. Seasoned: WAM between 22 and 28 years.

Figure 4

Number of Household Formations, 1960-2000 (in Millions)



Source: Census Bureau, U.S. Department of Commerce.

Declining housing turnover

Throughout the rest of this century, demographic forces should continue to moderate housing turnover. The number of first-time homebuyers is expected to fall during the 1990s as the number of households headed by 25 to 34 year-olds declines by more than four million. Figure 4 shows the annual increase in households since 1960, with Census Bureau projections through the year 2000. After factoring in immigration, total household growth is projected to slow from an annual rate of 1.6 million in 1988 to 1.2 million by the year 2000.

At the same time, the population will shift toward an older age group. The percentage of households headed by people under the age of 35 is expected to decline from 29 percent in 1985 to 20 percent in 1990, while households headed by the 35 to 54 year-olds will increase from 35 percent to 44 percent. Ordinarily, these older families bolster housing activity by trading up to larger, more expensive homes. This process, however, will be limited by the lack of entry-level home buyers.

Migration levels between states should moderate

The 1980s witnessed high levels of migration between states. In addition to the long-term trend of population movement from the Northeast and Midwest to the sun belt, economic disruptions increased the levels of migration. The energy boom in Texas coincided with the severe recession in the industrial Midwest and led to a doubling of migration into Texas during the early 1980s. The oil bust that followed in 1984 and the industrial recovery in the Midwest reversed this trend in the mid- and late 1980s.

The Census Bureau and The Joint Center for Housing Studies also provide longer-term projections for the rest of this century. These long-term projections, while tentative, point toward declining inter-migration between states. All of this data supports the conclusion that slower prepayment rates are likely to be a hallmark of the 1990s. **MB**

Michael Waldman is a managing director, and Ravi Mattu and Mark Gordon are directors in Salomon Brothers' BPA-mortgage department in New York.

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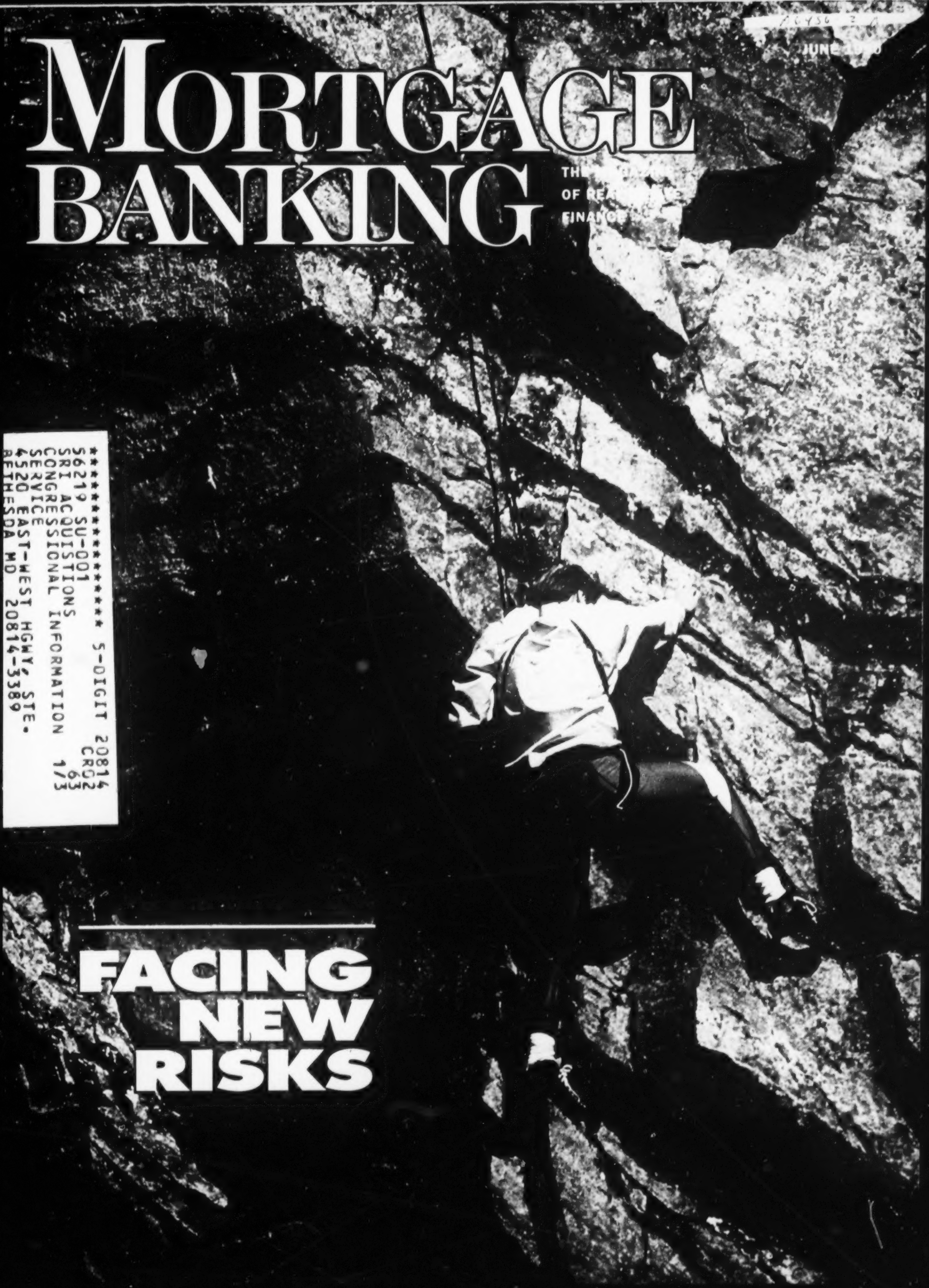

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FACING NEW RISKS

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JUNE 1990 VOLUME 50 NUMBER 9

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Servicing

What's easier—scaling the side of a vertical rock face or servicing a GNMA portfolio with loans in Colorado and Louisiana? The June issue does not attempt to answer that question but it does suggest there are some new high-risk factors on the servicing landscape. Additional obstacles now hanging over the heads of servicers include pending federal legislation that could lead to stiff money penalties for abusing consumers in servicing transfers. Other risks that stand out include the federal regulators' restrictive capital treatment of purchased servicing, servicing's delicate price situation with the RTC ready to liquidate a sizeable servicing stockpile and the apparent desire of the IRS to investigate the taxability of retained servicing.

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COVER PHOTOGRAPH BY DAVID LISSY / FPG

PORTFOLIO

SERVICING

A Real Cliff-Hanger

Just when you think you've got a real grasp on what it takes to make decent returns on a servicing operation, somebody does something that makes the ground fall out from under you. Perhaps the rock climber on our cover this month overstates the risks currently facing servicers trying to straddle the thin line between the red ink and the black. But increasingly, I suspect, servicers feel like they're being caught between a rock and a hard place.

Washington is the source of much of this anxiety. The FDIC's proposed regulation that puts a 25 percent limitation on the amount of purchased servicing that can count toward core capital is already creating a chill in the marketplace. Regulated institutions who buy servicing feel the proposed rule has once again shifted the playing field in a way that puts them at a marked disadvantage. Even the Resolution Trust Corporation is balking at the proposal because it makes it harder to find buyers for the RTC's growing inventory of servicing. The RTC's inventory is having its own impact on the servicing market—the overhang of government-held servicing is depressing prices.

Housing legislation moving through the U.S. House of Representatives is carrying provisions that affect mortgage servicers. The House version of major housing legislation contains provisions authored by Rep. John J. LaFalce (D-NY) that would create new money penalties that servicers could be hit with if a court finds they have shown a "pattern or practice of noncompliance" with the servicing transfer rules outlined in the bill. At the time this was written, those provisions also created the opportunity for aggrieved borrowers to press class action suits against servicers. The bill lays out rules for upfront disclosure to borrowers about the likelihood that the servicing will be sold. It also requires originators to detail for the borrower what past practice has been and whether there is present intent on the lender's part to sell that person's servicing. Then on top of that, the bill details what will be required as far as notice to consumers when an actual servicing transfer takes place.

The Internal Revenue Service is yet another Washington-based institution that has taken a new interest in the servicing business. A case in Michigan involving an IRS agent has raised some eyebrows. Reportedly, the lone agent, acting on his own, launched the theory that originated servicing should be taxed from the moment it is put on the servicer's books. A copycat case has reportedly sprung up in Texas, so the IRS is yet another federal entity that servicers should keep an eye on.

Janet Reilley Hewitt
Editor in Chief

Editor's Note: The May Economic Trends column was mistakenly edited to imply that it was the columnist's (Thomas M. Holloway) opinion that home prices peaked in 1988. This is not his view.

COMING IN JULY

An issue devoted to key trends in commercial real estate finance is in the works for next month.

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Servicing

The New Environment

A little self-knowledge can go a long way towards preparing lenders for servicing's most recent trends.

Two major trends are now quite clearly established in the mortgage servicing industry. One is the rising incidence of turnover in servicing assets. The other is consolidation of the number of players in the mortgage servicing business.

The capital regulations for thrifts mandated by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) will lead to further substantial changes in the supply and demand dynamics of the servicing market. These changes will promote further consolidation and foster a new trend toward tiering in the servicing market.

FIRREA permits both the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC) a role in the regulation of servicing assets on thrifts' balance sheets. The OTS capital regulations became effective in December 1989. They are generally directed toward the maximum permissible valuation of purchased servicing on the balance sheet and the degree to which the purchased servicing may be included in capital. While to date, the FDIC has only proposed servicing regulations in response to FIRREA, we anticipate that when finally adopted, they will generally direct themselves to the maximum percentages of capital that purchased servicing may represent on the balance sheet.

The OTS' capital regulations specify three distinct capital standards for thrifts: risk-based capital, core capital, and tangible capital. The capital requirement for servicing depends not only on each different capital standard but also on the form that the servicing takes.

Broadly speaking, servicing rights can appear in three different forms: retained servicing, purchased servicing, and capitalized excess servicing. Because retained servicing is seen as the residual processing activity that results from the servicer's own loan production, it does not appear as an asset on the servicer's balance sheet. Therefore, retained servicing is appropriately not addressed in the thrift capital regulations.

Capitalized excess servicing is the asset that results from the capitalization or present valuing of a portion of retained servicing fees that are above the GAAP defined normal servicing fee. Purchased servicing is operationally equivalent to retained servicing except that the servicer purchases the servicing as an on-balance-sheet asset instead of originating it. The treatment of the purchased and capitalized excess servicing assets varies importantly among the capital categories, as we will discuss.

OTS risk-based capital

Risk-based capital regulations generally establish four grades or classes of assets and set a different fraction of the required capital for each class of asset. The base capital requirement is 8 percent of assets, and those assets that are of superior creditworthiness are placed in a risk class that permits a lower specified fraction of the 8 percent capital. In the initial issuance of the capital regulations, both purchased and capitalized excess servicing were placed in the 100 percent risk class, thus requiring 8 percent capital. The OTS acknowledged that it placed servicing in the 100 percent risk class while many of the mortgages on which the servicing is performed are in a lower risk-weighted class. Since the current capital regulations treat only credit risk, the OTS decided to place servicing (and other assets with concentrated interest rate or prepayment risk, namely IOs, POs, residuals, and certain CMO tranches) in the 100 percent category until it issues the interest rate risk component of its capital regulation, presumably in the first half of this year. When the credit and interest rate risks are given separate capital standards, we anticipate that the credit risk class for purchased and capitalized excess servicing will be lowered toward that of the underlying mortgages.

OTS core capital

The regulations set 3 percent of assets as a minimum for core capital. The definition of core capital generally requires the deduction of intangible assets. Capitalized excess servicing is specifically defined as a tangible asset. While purchased servicing and supervisory goodwill are generally defined

Hal Hinkle, Steve Harris and Dick Loggins

FIGURE ONE

Amortized Book Value of Purchased Servicing

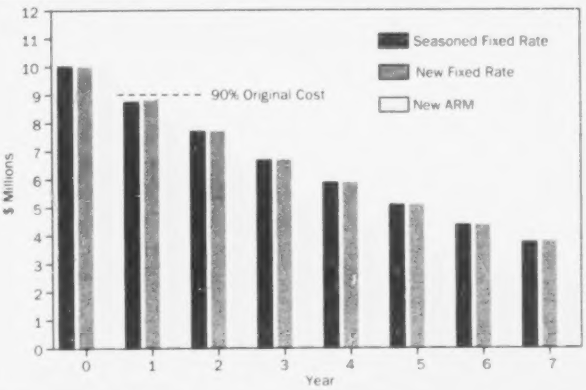


FIGURE TWO

Amortized Book Value Versus Amortized Book Value Plus Earnings

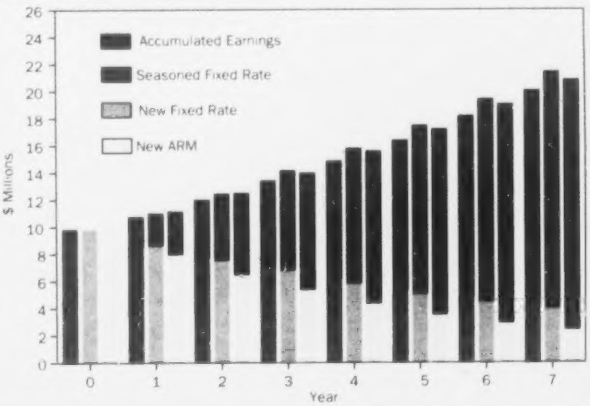


FIGURE THREE

Amortized Book Value Verses 90% Fair Market Value (200 bp decline)

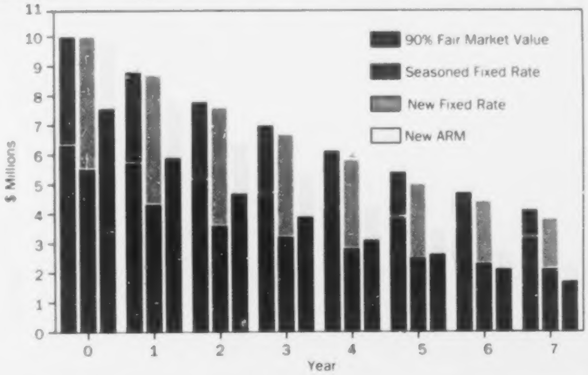
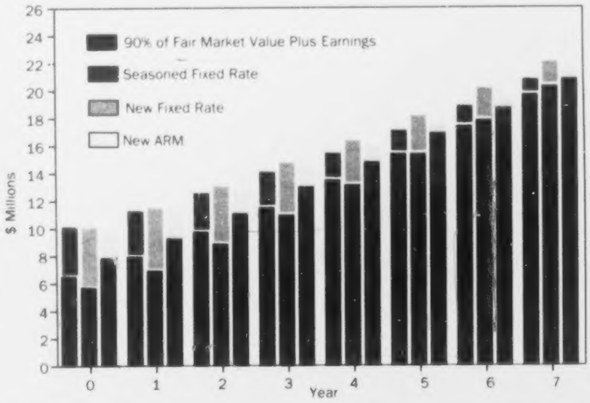


FIGURE FOUR

Amortized Book Value Plus Earnings Versus 90% of Fair Market Value (200 bp decline) Plus Earnings



as intangibles in the regulations, for the purpose of calculating core capital, they are counted or "included" as assets—but only up to a certain specific valuation limit. In the case of purchased servicing, the maximum portion or valuation that may be included in assets for the core capital calculation is the lesser of: 90 percent of the original cost, the current amortized book value as determined under GAAP, or 90 percent of the fair market value to the extent determinable.

The OTS capital regulations do not currently state the manner or frequency with which the servicing rights should be marked to market. However, the authorizing FIRREA language does state that the "fair market value of purchased mortgage servicing rights shall be determined not less often than quarterly."

OTS tangible capital

The regulations set the minimum tangible capital at 1.5 percent of assets. Similar to core capital, the definition of tangible capital requires the deduction of intangible assets. For tangible capital purposes, the one intangible that is still included in assets is purchased servicing. The "includability" of purchased servicing for tangible capital is still subject to the same maximum includable valuation conditions stated above.

The distinction between core and tangible capital is designed to be phased out. By January 1995, the stepped elimination of supervisory goodwill will leave both core and tangible capital effectively at the same general leverage limit of 3 percent.

FDIC maximum limitations

In addition to the above OTS capital regulations regarding the maximum valuation of purchased servicing that may be counted toward capital, FIRREA also potentially limits the percentage of a thrift's capital that can consist of purchased servicing. This regulation is issued by the FDIC. That the FDIC should play a regulatory role for a particular asset type is both curious in origin and possibly the most constraining in practice.

The general approach taken in FIRREA was to set thrift capital standards at levels no less stringent than those applied to national banks. The asset powers of national banks are regulated by the Office of the Comptroller of the Currency (OCC). Prior to the thrift crisis, the FDIC, the OCC, and the Federal Reserve had already adopted their risk-based capital adequacy regulations. On the matter of purchased servicing, only the OCC had specified the maximum percentage (not valuation) that can be included in assets when calculating capital. Specifically, the OCC set a limitation of 25 percent of Tier One (which is equivalent to core) capital that can be invested in

TABLE ONE

Thrift Participants in the Servicing Markets (as of 6/30/89)
($ millions)

	Insolvent Thrifts	Deficient Thrifts	Borderline Thrifts	Healthy Thrifts
Tangible Capital as a % of Assets	<0%	0%-1.5%	1.5%-3.0%	>3%
Number of Thrifts	521	150	277	2,206
Total Assets	$297,245	$151,038	$301,399	$656,667
Purchased Servicing	$426	$545	$616	$428
Excess Servicing	$349	$514	$757	$753
Loans Serviced for Others	$58,191	$69,056	$99,193	$152,482
Sources of Supply				
Estimated Retained Servicing	NR	$37,900	$64,000	$128,000
Estimated Latent Capital as a % of Assets	NR	0.25%	0.21%	0.20%
Sources of Demand				
25% of "Adjusted Capital" Core (1995)	NR	NR	$1,650	$9,671
Capital Capacity for Purchased Servicing	NR	NR	$1,276	$7,736

purchased servicing.

In its initial risk-based capital standards, the FDIC did not indicate a specific percentage limitation for purchased servicing. During the drafting of FIRREA, industry and constituent pressure prevailed on congressional staff so that the final language directed the percentage limitation to be "the amount that could be included if the savings association were an [FDIC-regulated] insured State nonmember bank," thus potentially obviating the OCC's 25 percent limitation.

Since FIRREA, the FDIC surprised and disappointed many by indicating that it would readdress its standing regulations on purchased servicing. On January 26, the proposed regulations were released and set a 25 percent of core capital and 50 percent of additional tangible capital limit. As proposed, there is a grandfather exemption of those servicing rights on institutions' balance sheets as of August 9, 1989. The exemption is proposed to phase out by December 31, 1994. Given the conservative nature of the OTS's maximum includable valuation requirements, there is some validity to the argument that FDIC should adopt a more liberal limitation than the OCC's.

Since servicing is naturally more prevalent in the thrift industry than it is in the commercial banking industry, even with this grandfather provision many individual thrifts could be severely affected by FDIC percentage limitation regulations. Specifically, there are over 20 thrift servicers with purchased servicing in excess of $1 billion dollars that would be affected without grandfathering.

Applying the capital standards

For years, thrifts, and to some extent banks, have compared investments on a return-on-assets (ROA) basis. The recent adoption of the comprehensive capital regulations for both thrifts and banks, however, will probably encourage a greater use of a return-on-capital or return-on-equity (ROE) measure for asset selection. In this regard, the OTS for thrift institutions has placed a severe capital handicap on purchased servicing. Further, because of the presence of three alternative treatments, just applying the OTS' standards will prove to be complex, and the effects may be surprising.

In a world of limited (and costly) capital, institutions must zealously guard the claims on their capital.

Under the OTS standards, both the availability of capital to support purchased servicing and the return on equity will affect a thrift's willingness to hold this capital intensive asset on its balance sheet. Even assuming effective capital requirements near 18 percent (10 percent haircut + 8 percent risk based requirement), the current levels of pre-tax returns on servicing can generate ROEs in the neighborhood of 40 percent. Although this is attractive when compared with traditional thrift business lines, sufficient capital must be available to support purchased servicing.

In a world of limited (and costly) capital, institutions must zealously guard the claims on their capital. The potential claims of the OTS' core and tangible capital requirements are important to assess, and the interplay of the three maximum valuation criteria produces some surprising implications for the acquisition and holding strategies for purchased servicing.

To illustrate the interplay of the three maximum valuation criteria, it is necessary to start with the simplification of ignoring the fair market value criterion. Figure One illustrates the interplay between the 90 percent of original cost and the current book value criteria for three acquired servicing portfolios. Each portfolio has the same original investment ($10 million) and the same projected internal rate of return (15 percent). Portfolio A is similar to the average portfolio implied in the Mortgage Bankers Association's *Income and Cost of Origination and Servicing of 1 to 4 Family Residential Loans*, i.e. a modest loan balance, seasoned, fixed rate portfolio. Portfolio B is a recently originated fixed-rate portfolio and Portfolio C is a recently originated ARM portfolio. Before interpreting the figure, it is helpful to recall that GAAP amortization of deferred premiums of purchased servicing is usually in proportion to the undiscounted expected net servicing revenues.

Note that the book value of the ARM portfolio declines considerably faster than the book value of the other two portfolios. ARMs generally season quicker and prepay faster than comparable fixed rate mortgages. Hence the balance on the portfolio will decline more rapidly. To obtain the same internal rate of return on the initial investment, an ARM portfolio (or any fast prepaying portfolio) will produce greater net revenues in its earlier years than a slow prepaying portfolio. The rapid decline of book value for an ARM or high coupon portfolio appears to make it unattractive from a capital standpoint. Given equivalent economics (and still ignoring the fair market valuation impact), the implication may be that a modestly capitalized thrift should prefer low coupon, long maturity or unseasoned servicing rights, since it will not impair capital as quickly.

When the earnings on purchased servicing assets are added back to capital, the risk of claims on capital changes substantially. Figure Two shows these same three portfolios with the earnings (pre-tax) added back to amortized book value. Specifically, note the surprising result for the ARM portfolio. Since the majority of its cash flows occur early, the ARM portfolio's contribution to capital will grow faster initially than the other portfolios. This is because its earnings stream is concentrated in its short period of positive net revenues. The perceived risk of high prepayments can apparently be more than offset by the effect of the front-loading of capital contributions.

This example highlights a subtle characteristic in the nature of the returns to servicing that merits specific mention. While a servicing portfolio may be said to have a certain positive internal rate of return, that internal rate of return is composed of positive net revenues during the early years and negative net revenues in the later years, once costs have risen and loan balances fallen. As a result, the accounting returns in the early years can substantially exceed the stated internal rate of return. Further, the faster the base rate of prepayment, the stronger the front loading of income. Thus, portfolios with presumed faster prepayment speeds may provide a better capital risk-to-return profile for thrifts than is commonly presumed.

When the fair market value criterion enters the capital picture, further complexity is injected, which we illustrate with three examples. First, even if price levels in the servicing market are generally unchanged, to the extent that a specific portfolio's market value declines naturally over time from seasoning and maturation, 90 percent of original cost will become irrelevant, since the same 10 percent haircut is applied to fair market value.

Second, the fair market value requirements are quarterly, thus overwhelming the initial 90 percent original costs if general market values fall. Third, if interest rates drop, the sensitivity or elasticity of prepayments to interest rates becomes an important factor. An ARM portfolio's prepayments do not increase as rapidly as a fixed rate portfolio's prepayments in a declining interest rate environment. Further, an extremely seasoned portfolio is relatively inelastic to changes in interest rates. In Figure Three we show the same three portfolios along with estimates of 90% of market value for a decline of 200 basis points (bp) at the end of each (though not cumulative) of the first seven years. The estimates assume a parallel shift of 200 bp for both refinancing rates and discount rates.

As can be seen in the figure, the portfolio that embodies a greater risk of capital claim is not necessarily easy to assess at the outset. The inelasticity of prepayments to interest rates for a well-seasoned portfolio and for an ARM portfolio allow them to withstand interest rate fluctuations without sustaining a dramatic reduction in capital.

Capital preservation, not prepayments in an isolation, is the risk that must ultimately be managed. With purchased servicing, capital is increased with revenues and deteriorates with prepayments or declining market values. In Figure Four the resultant capital on the balance sheet is shown for the current rate environment if interest rates drop 200 bp. In the current environment, portfolio B appears to have the best relative effect on capital. However, if interest rates drop 200 bp, the ARM portfolio with its front-loaded cash flows and relatively inelastic prepayment function would sustain its capital value the best.

Understanding the optimal implementation of the OTS's standards will be tricky. When analyzing a servicing portfolio, a thrift must examine not only the ROE but also when the cash flow occurs and what happens to capital if interest rates change. A thorough analysis of multiple prepayment scenarios should give a level of comfort to cash flow timing. Meanwhile an examination and implementation of hedging methods can mitigate the interest rate concern. Here,we certainly are not attempting to make an argument for the value of ARM servicing; rather, our analysis of the net capital impact of holding purchased servicing has indicated a better-than-expected outcome for ARM portfolios.

Impact on thrift servicers

For all of the far-reaching impact that the FIRREA-mandated capital regulations will have on the thrift industry's balance sheet structure, surely servicing will be one of the assets most pervasively affected. As thrifts set out to restructure their balance sheets to secure capital or improve earnings, the disposition or acquisition of servicing assets will be primary targets in many cases. In Table One we have segregated the thrift industry into four categories based upon levels of core capital adequacy. For each category, we will discuss the anticipated actions and resulting impact on the servicing market.

Insolvent thrifts. The vast majority of the insolvent thrifts will soon be subsumed within the Resolution Trust Corporation (RTC). Of the nearly $65 billion in servicing rights in insolvent thrifts, over 80 percent of them are held in about a dozen mortgage banking subsidiaries. To some degree, all of this potential supply can be seen as coming from one seller: the RTC and its advisors. Together, they have been undertaking a judicious and market-sensitive disposition of these assets to minimize market impact. To date, less than $5 billion has been transferred. In some instances the RTC is attempting to consolidate smaller units of servicing into larger servicers to improve the interim quality of servicing and make the ultimate sale more acceptable to the market. Ultimately, when these sales are executed, the complete portfolio will be liquidated. The timing of this supply will largely be determined by the funding constraints of the RTC and the valuation views of its advisors.

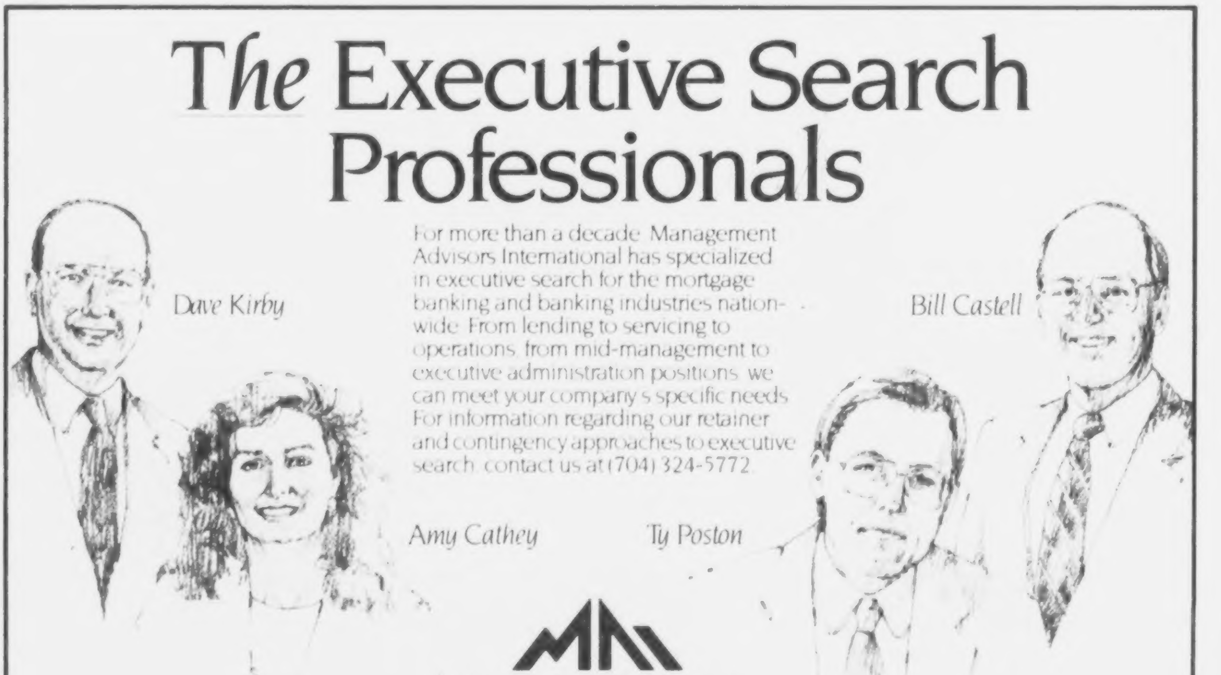
Capital-deficient thrifts. Sales of retained servicing rights, i.e., uncapitalized servicing, will be an important source of capital for capital-deficient thrifts. We estimate roughly that there is more than $30 billion in retained servicing rights held by capital deficient thrifts. If all of these rights could be sold for an average price of 1 percent of the unpaid principal balance, then an average thrift could improve its core and tangible capital by approximately .21 percent of assets, on a pre-tax basis. For many thrifts, this will represent an important source of capital. While the implied cost of capital from many servicing sales will be high nominally, in a number of cases, sales of retained servicing will be one of the few options available to raise capital. Accordingly, the supply of servicing will be increased in the future by sales from these institutions, though not necessarily by the full $30 billion.

Sales of retained servicing by those thrifts that have capitalized excess servicing on the same loans will be somewhat tempered. Current accounting constraints regarding gain on sale for subservicing transfers will lessen sales where the book value of the capitalized excess servicing is greater than the excess servicing's pro rata portion of sales proceeds. Likewise, agency restrictions on stripping excess servicing, split remitting, and subservicing responsibilities will also lessen sales where the book value of the capitalized excess servicing is greater than the pro rata portion on the sales proceeds. To the extent that the proceeds from the sale of total servicing (retained and capitalized excess) are greater than the book value of the capitalized excess, these sales will still be a source of capital.

In the end, to the extent that capital-deficient thrifts survive independently of the RTC, we expect that the final effect of servicing sales from capital deficient thrifts will add much less than .21 percent of assets to capital and result in perhaps less than $20 billion in supply of mixed investor and product type of servicing rights over the next two years. As these thrifts are taken over by the RTC, if their resolution is achieved by liquidation and not whole thrift sales, then a much greater portion of servicing will enter the market.

Borderline thrifts. Much of the motivation to sell retained servicing rights facing the capital-deficient thrifts is also present for the borderline thrifts. The lower the core capital of a borderline thrift the more powerful is the motivation to sell. As with the capital deficient thrifts, the presence of a high relative book value for any capitalized excess portion will lessen the motivation to sell. Of the estimated $64 billion of retained servicing held by borderline thrifts, we estimate that between $30 and $40 billion represent potential supply in the servicing market over the next two years. Thrifts with core capital closer to that of healthy thrifts, on average, will be buyers more frequently than sellers.

Healthy thrifts. Except for strategic restructurings of individual institutions, which may generate a limited number of servicing sales, we believe that healthy thrifts represent a considerable source of potential demand in the servicing market. Throughout most of 1989, thrifts as acquirors of servicing have been relatively quiet while they waited for the new capital regulations. Now that the capital consequences of owning servicing are



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being clarified, capital-healthy thrifts can now re-enter the servicing market as acquirors.

It is interesting to speculate about the amount of potential demand for servicing that may come from the re-entrance of healthy thrifts into the servicing market. From a capital capacity point of view, healthy thrifts, in aggregate, might represent potential demand equal to or greater than the potential supply from the more poorly capitalized thrifts. To illustrate, we calculated maximum capital capacity of healthy thrifts to buy servicing. Presuming that a 25 percent of core capital limitation applied, that an additional 20 percent valuation haircut was taken, and that risk-based capital was sufficient, the theoretical capacity of healthy thrifts to buy servicing would exceed $400 billion,or more than two times the maximum amount that the weaker part of the thrift industry could sell. By making these calculations, we are not suggesting that healthy thrifts will suddenly dominate the servicing market. Rather, we do believe that there is more potential demand within the thrift industry than has been generally thought in the marketplace.

Tiering in the market

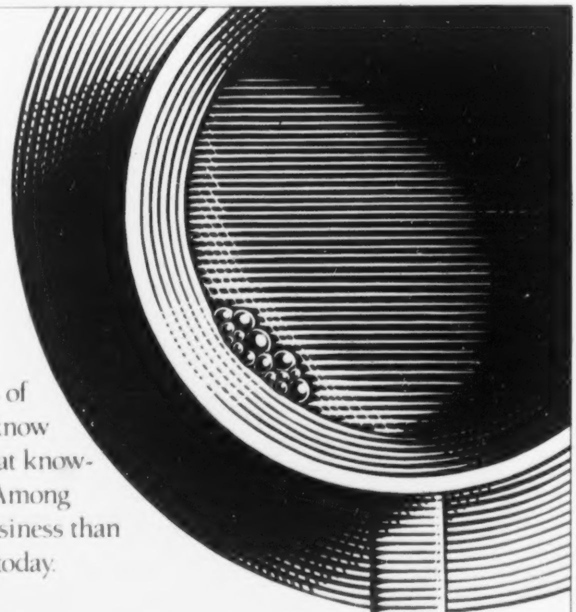
The above discussion has presented some of the changes in the supply and demand dynamics of the servicing market that may be wrought as thrifts respond to the new capital regulations. Obviously, the trends toward increasing turnover and consolidation will continue. More notably, the trend toward tiering will become increasingly visible and important. We conclude this report with a discussion of the tiering and the opportunities that can arise for individual participants.

Over the last several years, the bulk of supply in the servicing market has been somewhat homogenous, consisting of GNMA, Fannie Mae, and Freddie Mac fixed-rate products. The majority of these products has been put into the market by mortgage bankers. Now that thrifts are starting to provide an increasing supply, the distribution of product types in the servicing market is shifting. Historically, thrifts have been more active than mortgage bankers in recourse, private investor, adjustable rate, and other, less-commodity-like, servicing.

Many observers have confused this shift in the distribution of product types available in the market with a condition of oversupply. While it is true that the average price in the servicing market has declined over the last 12 months, we find that it is as much driven by a shift toward more lower priced types of servicing as it is by a shift in supply and demand. In order to properly evaluate the supply and demand conditions in the servicing market, participants must now fully recognize the trend toward tiering in the servicing market. High quality, large average-balance, fixed-rate servicing continues to be aggressively bid, while seasoned, recourse, adjustable rate or private investor servicing is scantily bid and sometimes not even bid at all. Clearly the occurrence of tiering in the servicing market makes it perilous today to talk in terms of historical relative prices.

Opportunities

The opportunities arising in the servicing market ultimately come not



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from the generally high level of nominal returns for servicing, but rather from the crude and inefficient pricing mechanism of the market, which frequently results in mispriced portfolios.

Two practices contribute to this mispricing. First, many servicers still have only a moderate understanding of their own operational and financial economics as well as their own relative strengths. Second, when evaluating and bidding targeted portfolios, servicers frequently adjust or bias their input assumptions toward their belief of market averages and levels instead of employing inputs directly reflecting their own operational and financial economics.

As tiering becomes accepted, buyers will have to take stock of their own comparative advantage relative to the plethora of product types being offered. Few servicers today can be said to be equally proficient at servicing every type of mortgage product. Each servicer should bid more aggressively for those products that fit its relative operational or financial strengths. Servicing has high nominal returns precisely because the returns are so uncertain. The more a portfolio fits the servicer's relative capabilities, the more likely it is that the servicer will earn a projected return.

To illustrate some of the opportunities that can arise when portfolios are priced to perceived average characteristics and assumptions:

- Servicers with strong collections and foreclosure departments can develop a niche in more delinquent portfolios.
- Servicers with strong capital bases can pursue recourse portfolios.
- Servicers with strong investor relations departments can focus on private investor portfolios.
- Servicers with a strong systems and customer service staffs can specialize in adjustable rate portfolios.
- Servicers with strong underwriting and due diligence staffs will be comparatively advantaged to pursue RTC portfolios, since only limited representations and warranties are usually provided.
- Servicers with a strong servicing cost per loan advantages can achieve superior returns on low loan balance portfolios as long as the market prices them to a higher average servicing cost.
- Servicers with affiliated balance sheets that possess considerable positive duration will benefit relatively from higher coupon portfolios.
- Servicers with sophisticated finance and interest rate risk management capabilities can pursue high servicing fees portfolio where the return profile can be significantly stabilized by use of derivative mortgage products.

In practice, of course, most portfolios are enough of a mixture of characteristics and product types so that the bidding manager must assess the predominance of those product types within a portfolio that fit the relative strengths of the bidding company. In the end, the most powerful evaluation tool that will contribute to the success of a servicer's acquisition (or restructuring) strategy is a little self knowledge. **MB**

Hal Hinkle is vice president, national product manager and director of the mortgage origination and servicing group at Goldman Sachs. Steve Harris is a Goldman Sachs vice president responsible for marketing servicing. Dick Loggins is an associate responsible for trading and hedging of servicing with Goldman Sachs.

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THE OVERBUILDING IS OVER

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PORTFOLIO

Don't Shoot the Messenger

This month we offer an unusual twist on the news. In this issue, we unintentionally became a forum for industry professionals to talk about what is wrong with the way commercial real estate market news is being reported.

As a result, in this month's issue, reporters are taken to task by industry critics who charge that the media has been administering the last rites to several real estate markets that are merely taking a restorative breather. One of our July contributors offered this comment to set the record straight: "U.S. real estate as a whole is not in the dire straits that many reporters suggest."

Another July author rebuts the common media portrayal of his market this way: "After highlighting other regions' real estate misfortunes for the past decade, it seems that the current media focus is to illuminate the negative trends of the Washington [D.C.] area's local economy...These headlines distract us from the essential fact that the Washington real estate market is not as bad as one may be led to believe. But then again, nor is it as robust as it once was." Clearly, a story about a market that is not as bad as some are saying it is, carries only modest news value–it is reporting on reporting, which is a step removed from real news. There is, however, an important news story in a market that is abruptly tapering off the torrid development pace it was setting only a short time ago. That significantly changed pace of development denotes some underlying change in the marketplace worthy of examination. And that is what news reporting is about–change–for better or for worse. But as the author of this month's piece about Washington's market points out, the underlying changes occurring in that marketplace are complex. And here is where much news reporting falls short. Financial marketplace complexities are not easily grasped and condensed into so many column inches.

Janet Reilley Hewitt
Editor-in-Chief

COMING IN AUGUST

Next month, we will explore some of the factors that determine where the business is going in the wholesale market. We will also look at the use of laptap computers to see what is behind all the talk about productivity gains.

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DISCOVERING Commercial Mortgage Statistics

Eric Stevenson

Digging through the piles of available information on commercial mortgages can be pointless, unless you know exactly what you are looking for and where to look for it.

Although financial institutions and commerical mortgage banking firms have an abundance of statistics relevant to the decision of whether or not to provide financing for a particular property (e.g., vacancy rates, absorption rates, demographics, rent levels, etc.), they have very little information about the business of commerical mortgage financing. The following two hypothetical memos, one from a chief executive and the reply from the head of the real estate department, suggest the questions that arise and the answers that can be given.

Following the memos is a description of where statistical information on commercial mortgages can be obtained and the sources used by the Department of Housing and Urban Development (HUD) for its monthly lending survey. The article concludes with some recommendations that the financial regulatory agencies collect more detailed information on commercial mortgages, following the example set by the American Council of Life Insurance for life insurance company investments.

Memo to the head of the commercial real estate financing department

From: Chief executive

The board of directors has asked me to discuss our share of the commercial mortgage market and to outline the directions that I think we should be taking to increase or decrease our market share. I believe it is important to compare ourselves to our competition, considering particularly our percentage of delinquencies. For this report, I will need by next week not only the most recent statistics on our commercial mortgage activity but also:

- The total amount of commercial mortgage holdings and originations in the United States, broken down by property type, and by type of financial institution.
- The commercial mortgage holdings and originations of institutions which are competitors of ours in the commercial mortgage market, giving the percentage of commercial mortgage assets to total assets held by each institution.
- The delinquency and foreclosure ratios on commercial mortgages in the United States, by location and by types of properties.
- Our costs of origination and servicing as compared with our competitors' costs.

Thanks for your prompt attention to this matter.

Memo to the Chief executive

From: Head of the commercial real estate financing department

In response to your request, I enclose the statistical information available and list the sources, but there are significant gaps in the availability of statistics for commercial mortgages as I will explain in this memo and a memo for the file. In the memo for the file, I conclude with some recommendations about statistics that you may wish to support in any discussion with others in the commercial real estate financing business.

Commercial mortgage holdings and originations

The total amount of commercial mortgage originations by lender group in the United States for 1989 is shown in Table 1 for permanent mortgages and Table 2 for construction loans. The total amount of commercial mortgage holdings by lender group as of December 31, 1989 is shown in Table 3. The source of these figures is HUD.

HUD does not collect statistics by property type, such as statistics for office buildings or shopping centers. It divides commercial mortgages between "multifamily" and "nonfarm nonresidential." The statistics cover almost all lender groups in the commercial mortgage market, except mortgages held by individuals or partnerships, mortgages held by credit corporations, mortgages held by REITs, and mortgages held by foreign institutions.

The American Council of Life Insurance (ACLI) publishes commercial mortgage statistics by property type, regional or metropolitan area location, and interest rate and yield, mortgage structure (e.g., fixed-rate or joint venture), and debt service coverage, but these statistics, of course, are applicable only to mortgages of life insurance companies.

Competitors' statistics

As for your request for data on our competitors, you know that commercial banks and savings banks insured by the FDIC submit quarterly call reports, and institutions insured by the Savings Association Insurance Fund submit monthly thrift financial reports. The banks, for example, report quarterly (a) construction and land development loans of 60 months or less, (b) multifamily housing loans on five or more units, and (c) nonfarm nonresidential loans, excluding, of course, construction and land development loans of 60 months or less.

Several firms, including Sheshunoff Information Services of Austin, Texas and Ferguson & Company of Irving, Texas sell the data bases plus software for the call and thrift financial reports, so that we can generate our own analyses. Alternatively, these firms will do a custom report on any financial institutions you wish. Analysis can be done showing ratios of mortgage assets to total assets, by location of bank headquarters, or by several other criteria available in the data base. There is no information by property type or by location of the property on which the loan is made. Given the short deadline, I have not sought this information on our competition.

Delinquency and foreclosures

Although national delinquency and foreclosure statistics are available for one-to-four family houses, they are not available for commercial mortgages, except for those held by life insurance companies. ACLI publishes quarterly a survey which shows amount and ratio to mortgage loans outstanding, of loans delinquent, loans in process of foreclosure and loans foreclosed during the year. It is indexed by type of property and the figures are shown for nine geographical regions. This kind of detail is important because, for example, on March 31, 1990, the nationwide delinquency rate of commercial mortgages held by life insurance companies was 3.04 percent, yet the delinquency rate in the eight

TABLE 1

Permanent Mortgages Originated in 1989 (all figures in millions)

Type of Institution	Multifamily	Nonfarm Nonresidential	Total
Commercial Banks	$ 7,669	$106,424	$114,093
Mutual Savings Banks	2,059	4,880	6,939
Savings & Loan Assns	11,410	9,956	21,006
Life Insurance Companies	2,786	25,675	28,461
Private Pension Funds	44	507	551
Mortgage Bankers	4,443	1,688	6,131
State & Local Ret. Funds	4	95	99
Federal Credit Agencies	1,194	443	1,637
State/Local Invest. Agn.	1,536	642	2,178
Total:	$31,145	$149,950	$181,095

(Source: HUD 04/17/90)

TABLE 2

Construction Loans Originated in 1989 (all figures in millions)

Type of Institution	Multifamily	Nonfarm Nonresidential	Total
Commercial Banks	$30,322	$120,934	$151,256
Mutual Savings Banks	1,450	2,733	4,183
Savings & Loan Assns	3,827	4,514	8,341
Life Insurance Companies	69	183	252
Private Pension Funds	0	1	1
Mortgage Companies	434	1,717	2,151
State/Local Retire Funds	11	0	11
Federal Credit Agencies	370	0	370
State/Local Invest. Agn.	1,307	367	1,674
Total:	$37,801	$130,449	$168,250

(Source: HUD 03/30/90)

TABLE 3

Holdings of Multifamily and Nonresidential Construction and Long-Term Mortgage Loans, December 31, 1989 (all dollars in millions)

	Construction			Long-term		
Investor	m/f	nonres	total	m/f	nonres	total
Com. banks	$17,965	96,383	114,348	19,077	205,971	225,048
Mutual banks	3,304	4,441	7,745	14,513	24,477	38,990
Savings & loans	13,654	11,559	25,213	76,489	88,563	165,052
Life Ins. Cos.	122	594	716	21,515	193,486	215,101
Pension funds	—	20	20	782	2,965	3,747
Mortgage Cos.	336	4,734	5,070	275	1,357	1,632
St. & local ret.	12	—	12	5,166	7,078	12,244
Fed. Credit agencies	880	—	880	31,261	4,690	35,951
Mortgage Pools	—	—	—	22,729	79	22,808
St. & local credit	1,808	2,379	4,187	39,090	5,456	44,546
Totals	$38,081	120,110	158,191	230,997	534,122	765,119

Total holdings: Construction plus long-term $923,310

(Does not include farm properties or land loans.)

(Multifamily combines FHA-insured and conventional.)

(Source HUD 4/17/90)

states of the mountain region was 8.20 percent.

The Office of Thrift Supervision (OTS) issues statistics on mortgage delinquency rates, but there is just one percentage given for each of three categories: "Construction and land," "Home" and "Other." The delinquency ratio for "Other" for savings associations not in conservatorship was 4.2 percent in October 1989. The definition of "delinquency" for thrifts is any loan past due, depending on the definition used by the thrift, whereas the life insurance companies consider delinquent, for monthly payment loans, any loan two or more payments past due.

On the call reports for commercial banks, past due (30 to 89 days) mortgages are all in one figure with no division between single-family, construction or commercial mortgages. The FDIC publishes delinquent real estate loan ratios for banks by state each quarter.

In short, you will have to rely on comparisons with life insurance companies for delinquencies and foreclosures because no other useful statistics are available.

Costs of origination and servicing

There is virtually nothing available, that I know of, regarding the costs of origination and servicing commercial mortgages, either by mortgage banking firms or by financial institutions. The Mortgage Bankers Association of America (MBA) publishes yearly "Financial Statements and Operating Ratios for the Mortgage Banking Industry" but it is primarily for those in the single-family mortgage business. Only five companies doing 100 percent commercial mortgages responded to the 1988 survey for this report, an insufficient number to provide guidance. A number of companies surveyed do both single-family and commercial mortgage business, but the costs are not separated by type of business.

One report, prepared by ICM Consultants, Inc. of Valley Forge, Pennsylvania, covers costs of origination during the past five years among a group of commercial mortgage banking firms represented by ICM. It is available for sale for $165. Other management consulting firms may also have done studies on either originations or servicing, but I have not seen them.

One of the difficulties in doing a study of servicing costs is that many firms combine single-family residential servicing with commercial servicing and have no easy way of separating the costs. A more basic problem, however, is that commercial servicing revenues generally exceed the costs until a property is in trouble. The time spent on delinquent loans may be brief or may be extensive. In the commercial real estate mortgage market, it is virtually impossible to predict, or average out, the expense of delinquencies, workouts and foreclosures.

This may be all the information you need for the board of directors.

Memo to the file

The sources of information that I could find are covered in Section A. Section B discusses the HUD monthly lending survey and Section C has recommendations for more detailed data collection.

Section A—Where to obtain information

HUD—"The Survey of Mortgage Lending Activity" is published monthly by HUD. Each quarter the survey includes the holdings of land loans construction loans, and long-term mortgage loans by 11 lender groups. Tables 1 and 2 show nine lender groups, because two groups do not originate commercial mortgages.

This survey is issued as a press release by HUD. The press release appears about three to four months after the date of the statistics. The current mailing list is about 2,500, to libraries, trade associations and others. Those who wish to receive a copy or be added to the mailing list should call the HUD Office of Public Affairs at 202-755-6980.

ACLI—Each quarter, ACLI publishes an investment bulletin titled, "Survey of Mortgage Commitments on Commercial Properties." The reporting life insurance companies hold two-thirds of the commercial mortgages held by U.S. life insurance companies. The survey appears about five months after the date of the data collected.

The survey shows the amount of mortgages committed during the previous quarter by seven types of property. A further breakdown is by fixed-rate, fixed-term mortgage, participation (income/equity), joint venture, land sale leasebacks and other structures. The average loan amount and interest rates and yields and debt service coverages are included. Next, the mortgages are divided into several classifications of company size. There are statistics on amortization provisions and classifications by loan size. Finally, there is a breakdown by loan type by states and by certain metropolitan statistical areas.

The "Survey of Mortgage Commitments" is sold for $55 a year. The quarterly report may be purchased by calling ACLI at 202-624-2370.

ACLI's "Delinquency and Foreclosure Survey" may be obtained when available, by telephoning 202-624-2126.

Realtors—The National Association of Realtors publishes twice a year a paper titled, "Financing Investment Real Estate." It is based on a questionnaire that goes to a mailing list of nearly 15,000 commercial real estate members in the organizations associated with the NAR, such as the Certified Commercial Investment Members. The mailing is also sent to the members of the Urban Land Institute and commercial members of the National Association of Homebuilders. The respondents are asked to submit information on two recent financing transactions. The results are then tabulated to help evaluate trends, interest rates, terms of loans and other factors. A copy of the report may be obtained by calling Patria Smith at 202-383-1221.

Federal Reserve Bulletin—The Federal Reserve Board publishes each month a table titled, "Mortgage Debt Outstanding" which is broken down by banks, savings institutions, life insurance companies, federal and related agencies, and mortgage pools or trusts and individuals. For commercial mortgages, the division is between multifamily and commercial. Some of the figures come from the HUD survey, but the figures on "Individuals and Others" are derived from Federal Reserve estimates. "Others" include mortgage companies, real estate investment trusts, and the categories covered by HUD but not specifically listed in the bulletin tables. For example, the total holdings of "Individuals and Others" at the end of the third quarter of 1989 was estimated to be $81,009 million in multifamily loans

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The 1989 survey results were published in the May edition of The ICM Journal, the monthly management letter on mortgage banking.

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and $69,690 million in commercial loans.

American Banker—The *American Banker* provides lists of the largest servicing portfolios of mortgages held by 88 commercial banks, 100 top thrifts and 300 mortgage companies. Unfortunately, there is no division between single-family residential and commercial mortgages. One can tell by the number of loans that seven of the top hundred mortgage companies service only commercial mortgages, but many other firms service both, and there is no way of knowing what percentage of the portfolio is commercial. There are no lists of the top firms or institutions which originate commercial mortgages. The *American Banker Top Numbers 1990* is available for $55 from *American Banker*, One State Street Plaza, New York, New York 10004.

Secton B—The HUD monthly survey

Sources of information for the HUD survey—For the nine lender groups, the HUD survey:

- Uses its own survey for commercial banks and mutual savings banks insured by FDIC.
- Obtains figures from the OTS for savings and loans.
- Uses figures from the ACLI for the life insurance companies.
- Contracts with a private research firm to do a survey of private pension fund mortgages and state and local retirement fund mortgages.
- Uses figures from a survey of the MBA for origination and holdings of mortgage companies. The MBA reports, in addition to one-to four-family loans, multifamily residential (FHA-insured and conventional, separately) and nonfarm nonresidential. Reports cover only those loans made, originated or closed directly with a borrower in the name of the mortgage banking firm. In the commercial real estate financing business, multifamily loans sold to Fannie Mae or Freddie Mac are among those originated in the firm's name. Most commercial mortgages, however, are originated in the name of the life insurance company, savings bank, or other investor with the mortgage banker arranging the financing but not funding the loan.

The information obtained by the MBA from 78 companies is expanded by a carefully designed expansion factor to represent the universe of mortgage banking firms. This expansion factor does not differentiate between one- to four-family houses, multifamily and nonresidential.

- Uses statistics from Fannie Mae, Freddie Mac, GNMA and the Farmers Home Administration for statistics on "Federal Credit Agencies."
- Uses information from *The Bond Buyer*, published by *American Banker*, for statistics on tax-exempt and taxable financing from state and local investment agencies, which are primarily state housing finance agencies.

Accuracy of HUD survey of banks—For the commercial banks and the mutual savings banks insured by the FDIC, the Office of Financial Management at HUD conducts its own survey. In 1970, it initiated the survey with a sample of 250 banks carefully selected to ensure that the sample reflected commercial banking as a whole. Some of the banks originally contacted have gone out of business and some have now refused to respond to the survey, but HUD states that the larger banks are all represented. The sample is based on the universe of all real estate mortgages, not total assets held by banks, but only one expansion factor is used to translate the sample's results into totals for all banks. There are no separate expansion factors for single-family mortgages, multifamily or nonresidential mortgages. This expansion factor is revised every six months. A complicated software package containing information from the call reports, is used to determine the expansion factor.

The fact that HUD has been using a sample that is 20-years old with a questionnaire that has not been changed for 20 years provides cause for concern. One wonders about whether or not the expansion of the figures collected to the total of commercial bank financing is accurate. Holdings reported in the HUD survey are verified by the call reports submitted by the banks, but the monthly lending reports depend on the relationship of the sample collected to the entire commercial mortgage portfolio for all banks.

It should be noted from Tables 1 and 2 that the commercial banks in 1989 originated about 90 percent of the construction loans, which is no surprise, and about 77 percent of the long-term mortgages, which is a surprise to many real estate financing professionals.

One reason that so many construction loans become "long-term" loans held by commercial banks may be explained by an example. Suppose that a bank makes a three-year construction loan, giving the borrower sufficient time to find a permanent mortgage after construction is completed. Suppose the construction is completed within two years, but the borrower decides to keep its loan for the full three-year period. The HUD reporting requirements state that, when the construction is completed, the bank should treat the remaining portion of the loan as a long-term or permanent mortgage.

Section C—Need for more detailed statistics

Financing by institutional lenders for multifamily housing and nonresidential buildings, both construction and long-term mortgages, totaled nearly $350 billion in 1989 and yet we know virtually nothing about these figures. Only the life insurance companies provide information on types of properties financed, locations of financing, structures for lending, interest rates and yields. Only the life insurance companies provide detailed information on delinquencies and foreclosures.

There may be no particular need for a monthly survey of mortgage lending from HUD; a quarterly survey would probably be sufficient. There is a need to determine the extent of financing for particular types of buildings. It is important, for example, to those building or owning hotels, or those who finance hotels, to know the increase or decrease in the amount of hotel financing quarter by quarter. Yields and interest rates should be collected after closings so that mortgage officers can compare return on commercial mortgage portfolios with that on bonds or common stocks or real estate ownership. Also, given the fact that many people blame commercial real estate for the savings and loan disaster, it is important to keep an accurate delinquency and foreclosure record for commercial real estate.

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nation Council, should work with the FDIC and OTS, plus the other lending groups in the HUD survey, to develop a good sample of commercial mortgage investors. The sample should reflect the commercial financing business as a whole, and should be changed from time to time as the business changes. Credit corporations and foreign mortgage lenders should be included. A group of professionals in commercial real estate financing should provide advice on what kind of information would be available or could be programmed on institutional computers and what information is particularly needed for the business. Detailed information on delinquencies and foreclosures may not prevent a real estate crisis, but it can provide help in developing lending strategies, and it does give valuable clues to the state of the economy.

A separate study is needed annually on real estate owned (REO). Three employees of the OTS did a survey of a sample and expanded it in the Spring of 1989 to estimate that REO on March 31, 1989, held by regulated and non-regulated financial institutions and the government totaled $16.7 billion in multifamily $5.9 billion in office, $2.6 billion in retail, and $1.5 billion in mortgages on hotels and motels. They could not provide percentages of REO to total commercial mortgages held. Their report has the splendid title of "Flying Down with REO" and it appeared in the December 1989 issue of the *OTS Journal*.

Those involved in the real estate financing business need more information about market share and the cost of doing business. We have no statistics, for example, on the amount of commercial mortgages serviced by mortgage bankers as distinct from those serviced by financial institutions. We do not know the share of commercial mortgage originations originated by mortgage brokers. The costs of origination and servicing are unknown. It's surprising that, given the importance of commercial real estate to the nation's economy, we know so little about the trillion dollars of mortgage holdings. **MB**

Eric Stevenson is senior staff vice president of the Mortgage Bankers Association of America, Washington, D.C. Linda McKenna, staff assistant at the MBA, assisted with statistical information.

AG450-2

AUGUST 1990

MORTGAGE BANKING

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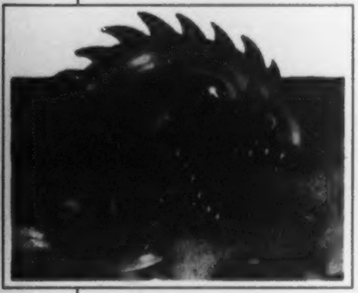
AUGUST 1990 VOLUME 50 NUMBER 11

COVER:

Mortgage Brokerage

A successful wholesaler has to think about keeping the customers satisfied. And to keep correspondents bringing their loans to your door, you have to present the best face you can on three crucial fronts—price, products and service. Our cover this month depicts these three faces of wholesaling—the bedrock upon which a successful purchase program rests.



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COVER ILLUSTRATION BY SAM WARD

PORTFOLIO

Wholesale Is Big Business

The mortgage banking industry continues to watch as more of its own convert to wholesale. Increasingly, new buyers are cropping up in niches that serve their strategic goals. And sellers setting up their own small shops continue to proliferate, as large retail operations are pared back, merged or shut down.

In our cover story we tried to catch a glimpse of what it's like to be a major purchaser of loans in today's market. And, as it turns out, what it's really like is busy—really busy. At least that was the word from the three wholesalers *Mortgage Banking* sat down with in New York earlier this year.

Although we started out pursuing the views of both buyers and sellers, we ended up with a story focused only on what the buyers see as some important issues of the day. One of those big issues was the land-office business created, at least in part, earlier this year by the risk-based capital rules. It turns out that around the start of this year, many managers of bank- and thrift-owned mortgage production outfits realized that one of the only feasible ways of meeting the parent's new capital requirements was to sell off assets. Living within the capital rules meant many banks and thrifts could no longer continue to grow their asset base by retaining the servicing produced by their origination operations. That, in turn, translated into unexpected volume for some large wholesalers whose niche is buying from bank and thrift correspondents. Our cover story focuses on how the buyers of that production were forced to adjust to handle the runaway volume.

As for the mortgage brokers and other correspondents that we count among our readers, we promise yet another article that sums up the wholesale business from your point of view. Then, we can really get into the subject of turnaround time and persnickety underwriting. Until then, we will let the buyers tell it their way.

Janet Reilley Hewitt
Editor in Chief

COMING IN SEPTEMBER

The internal workings of a mortgage company and how managers can make them work more smoothly and more profitably is our focus next month. Featured is an article releasing the latest results from KPMG Peat Marwick's 1989 Mortgage Servicing Performance Study.

MORTGAGE BANKING
THE MAGAZINE OF REAL ESTATE FINANCE

VOLUME 50 NUMBER 11

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WHOLESALE COMPETITION

How important is it to be the preferred buyer for a correspondent? It may be more critical than you think, a new survey shows.

Jeff Lebowitz

Correspondents will sell twice the volume to the wholesaler designated as their primary relationship than they will to the number two firm. That is what a just-completed survey on wholesaler-correspondent relationships revealed.

If you are not the primary wholesale outlet, the opportunity cost of not being the first choice of a correspondent is greater than you think.

The selling behavior of an array of correspondents reveals some interesting patterns. The numbers are compelling. The mortgage wholesaler chosen as the preferred buyer of loans is two and a half times more likely to receive more than 25 percent of a correspondent's product than is the seller's second choice for a wholesale outlet.

Once a group of correspondents are selected that complement the wholesaler's production strategy (byproduct, geography, pricing structure, growth and quality goals), the primary marketing objective becomes increasing the share of product sold by each firm. What exactly is involved in pursuing such an objective?

Characteristics of correspondents

The first factor to understand is how your correspondents behave in the marketplace.

Correspondents are usually small shops. But it is helpful to know how small. The figures developed in the Wholesaler Quantitative Survey show distribution of origination volume at the end of 1989. The survey results are based on an analysis of the responses prepared by SSP/RES Research, Washington, D.C. These results clearly suggest that the wholesaler is supporting a small originator in dealing with the typical correspondent. Almost 73 percent originated $100 million or less in 1989. According to Mortech 90, another study performed by SSP/RES Research, 69.8 percent of mortgage banking firms and thrifts originate $100 million or less.

From this 100 million or less group, on average, a wholesaler would stand to get a maximum of $58 million in production, if a typical correspondent were to sell all its production to a single firm. However, the SSP/RES survey shows there is less than a 50 percent chance (46.5 percent) that a correspondent will sell all its production to the secondary market. Even the primary respondent for the typical correspondent surveyed stands less than a 50-50 chance (45.5 percent) of buying as much as 50 percent of that originator's product. That amounts to having one chance in five of buying half of a correspondent's current production. If the wholesaler is in a secondary position as a favored wholesale outlet, the probability falls to about one chance in ten for getting half of a seller's production. Carried further, the wholesaler in the third position has about two chances in a hundred of getting at the lot of a correspondent's current production.

Increasing business

One way of meeting business objectives would be simply to line up as many correspondents as possible. For every 50 correspondents signed up you might bring in $58 million in production. But, what about the competition in the wholesale business?

The survey found that 47.3 percent of correspondents have relationships with two to five wholesalers. More than one-third of correspondents responding to the survey—36.3 percent to be exact—do business with six to ten of the firms competing as wholesalers. The principal objective for the wholesaler is to reduce the correspondent's number of active wholesaler relationships to as close to one as the market and economics allow.

Generally, it is more efficient to increase volume from existing customers than it is to build new relationships. The SSP/RES Mortech 90 study indicates that more than half of the firms in the mortgage industry currently sell no loans to wholesalers. Therefore, finding potential sellers that meet your performance standards is a challenge in and of itself. Once you have located them, turning new accounts into worthwhile relationships becomes a formidable marketing task. The Wholesaler Quantitative Survey shows that correspondents are likely to be very satisfied (34.7 percent) or satisfied (41.1 percent) with the overall performance of their primary wholesale relationship. Therefore, getting correspondents to switch allegiance takes understanding, organization and good execution.

Capturing market share

Wholesalers are confronted with the tough task of trying to isolate good correspondents and woo them from current relationships that are typically not unsatisfactory. Capturing the hearts and minds of new correspondents requires execution of business fundamentals in the most single-minded and dedicated way.

For those in the wholesale business, the first objective should be to retain, and then, improve existing relationships. It is as important to understand why correspondents abandon a business relationship with a wholesaler as it is to open a new account. The three categories of reasons revealed in the survey for diminished wholesaler relationships are as follows: pricing (36.9 percent), underwriting (25.6 percent) and customer service (15.9 percent).

CAPTURING THE HEARTS AND MINDS OF NEW CORRESPONDENTS REQUIRES EXECUTION OF BUSINESS FUNDAMENTALS IN THE MOST SINGLE-MINDED AND DEDICATED WAY.

Pricing

A wholesaler's pricing performance is viewed by correspondents from two perspectives—competitiveness and consistency. Proper pricing depends on being close to market, but, as important to survey respondents was the wholesaler's maintaining that competitive price. In fact, larger correspondents indicated they regard consistency in pricing as more important to them (50.5 percent) than pricing competitiveness alone (38.7 percent).

Correspondents need to receive clear and consistent pricing policy information. As a trading partner, a correspondent should have a current understanding of the wholesaler's pricing policies (in addition to price quotes). By using all available media with correspondents, a wholesaler can hope that sufficient display and repetition of pricing information will eliminate ambiguities. Printed pricing information (pricing manuals), electronic display (electronic bulletin board pricing information), and account executive consulting can be used in combination to help ensure that correspondents understand current pricing details and strategies. Repetition is often a precursor to knowledge.

Junk fees emerged in the survey as an issue that needs attention. Complicated pricing that includes a host of miscellaneous charges is a put-off to a significant number of correspondents (9.4 percent). Such yield enhancements are transparent and occasionally force a correspondent to take his business elsewhere. Minimizing the use of junk fees will simplify communication and streamline the administration of a trading relationship.

Underwriting

Among current primary wholesaler relationships, unclear and inconsistent underwriting policies was the factor most likely to cause concern for correspondents. Of all relationship-defining factors, correspondents are likely to be least satisfied with underwriting in their primary relationship, the survey found.

The two major factors that correspondents are least satisfied with in the area of underwriting are consistency and the time it takes for a wholesaler to arrive at an underwriting decision. Note that correspondents were not expressing concerns about the wholesaler's basic underwriting principles, but with the operational and

CHART 1

Loan Sale Behavior

Percent of Correspondents' Sales	Sold to Primary Wholesaler	Sold to Secondary Wholesaler	Sold to Tertiary Wholesaler
51%+	18.8%	1.4%	1.6%
26%-50%	45.5%	23.8%	9.4%
25% or less	30.5%	70.7%	85.2%

Source:Wholesaler Quantitative Survey

CHART 2

Origination Volume	% of Firms Originating
$50 million of less	47.9%
$51-$100 million	24.7%
more than $100 million	22.7%

Source:Wholesaler Quantitative Survey

CHART 3

Assessing Wholesaler Service

Service Component	Percent Correspondents*
Timely resolution	39.6%
Negotiation flexibility	16.8%
Access to decision-maker	13.9%

*Note: percent stating primary concern.

Source: Wholesaler Quantitative Survey

informational issues that surround the underwriting process.

Timeliness in decision-making is the cornerstone to building a lasting business relationship with a correspondent. According to the Wholesaler Quantitative Survey, taking more than two days to return an underwriting decision could wear unnecessarily on relations with a correspondent. In the not-too-distant future, a one-day turnaround may become the industry standard. At minimum, wholesalers should be monitoring regularly elapsed time from underwriting inquiry to the return of a decision.

Organizing the underwriting department to enable it to be responsive to customer operational needs is critical. Technology, adequate to meeting service needs, is available and has been adequately field-tested. Electronic links to credit bureaus, appraisers and the primary market can reduce markedly the time for gathering underwriting data. Actual decision-making can be aided and accelerated through the help of artificial intelligence. Such systems are still in the experimental stage, but wholesalers should monitor their development. The lead time (a minimum of one year) for integrating the underwriting process into an artificial intelligence system has to be factored into your thinking.

The consistency of underwriting decisions is partly an informational issue. Similar to pricing, communicating the principles of underwriting and the reasons any policy changes are made, is critical to correspondent understanding and satisfaction. Manuals, bulletin board updates and account executive briefings are the essential means available to help knit correspondent and wholesaler operations more closely together.

Another key to delivering consistency in underwriting performance is that wholesalers must make certain that everyone involved in the business relationship with a correspondent is coordinated in thought and in action. Everyone on the wholesaler's staff must be singing from the same hymnal, in tune, and on time. All underwriting documentation should be kept current. Staff should be in-

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formed, trained and kept up-to-date. Merely circulating memos and documentation is never sufficient to ensure that underwriting principles and guideline changes are adequately communicated.

Service

The fundamental message being stressed in business schools and by management consultants today is that the key to remaining competitive rests on your ability to provide and maintain product and service quality. After studying thousands of business cases, the Strategic Planning Institute, Cambridge, Massachusetts, concluded that firms perceived to offer superior quality are likely to be twice as profitable (return on investment) as those demonstrating inferior quality. It appears that the perceptions that customers have of the quality of your performance are, in the long run, of equal importance to the substance that underlies quality performance.

The Wholesaler Quantitative Survey asked correspondents about service concerns that were raised by the nature of their relationship with their number one wholesaler. Chart 3, assessing wholsaler service issues, highlights the results.

Clearly, the primary service issue brought up by correspondents responding to the survey was the difficulty they have in obtaining timely responses to inquiries and to problems raised with the wholesaler's staff. Normally, the primary contact between a correspondent and the wholesaler is through the account executive. In order to improve service levels, it makes sense to assign support staff to each correspondent to field day-to-day inquiries. The account executive is then freed to spend more time marketing. Whenever possible, it appears worthwhile to try to reduce the number of people involved between the receipt of an inquiry and the delivery of an answer.

A wholesaler's complete service package incorporates underwriting, funding, problem resolution, and servicing. Management's responsibility is to measure and maintain the level of service so as to make it superior to the competition. But quality has two aspects— conformance and perception.

Conformance means actually setting up procedures that reduce operating errors and that allow rapid response to changing market needs and conditions. Perceived quality is a concept of relativity—relative to a competitor's performance and relative to the correspondent's expectation of what your performance should be. Managing perceived quality requires surveying your customers about their perceptions and also requires formal monitoring of the service offered by competitors.

The potential rewards of providing superior service are considerable. They include greater correspondent loyalty, increased pricing latitude, lower marketing costs, increased volume from existing customers and improved market position and share. Clearly, large dividends can be reaped from instituting a formal program for improving the quality of service offered to correspondents.

Putting it all together

The plan to become "number one" in the eyes of your correspondent requires a systematic review and

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updating of all aspects of your service package. That includes how you measure up in the following areas: pricing, servicing, funding, product array, staffing, underwriting and customer support.

The staff member closest to the issues and in the best position to manage the assessment of service quality is the head of correspondent banking. The argument that a correspondent is more than a source of production; it is a separate business—is an argument with merit. Most aspects of the correspondent relationship are tied to the fundamental business of the wholesaler, but the relationship does contain its own unique properties. The product line offered to correspondents may differ from that offered through retail production. Certainly, product pricing is unique. The correspondent has its own set of customer sales and service needs. The competitors the wholesaler faces are unique to that line of business. Even the measures of performance, control and compensation may be specialized and differ from the other sources of production within the firm.

The head of correspondent banking is really the president of a distinct line of business. They need the budget and management authority to make decisions rapidly that benefit that unique segment of the business. The primary connection between wholesale and the rest of the company is through secondary marketing. One way to conceive of this relationship is to think of secondary marketing as the primary buyer of product from the correspondent business. If a correspondent is unhappy with the price or terms offered by marketing, is there a compelling reason why the head of the correspondent program should be barred from selling directly into the secondary market?

The measure of success, ultimately, is the total profitability of this line of business, as well as the entire firm. Some mortgage companies charge back marketing losses to the correspondent business, but do not give that sector credit for marketing profits. Such practices blur the real performance of the wholesale business.

After reviewing the unique management terrain of the wholesale business, one thing becomes clear. The crucial element of an effective management philosophy lies in giving the head of correspondent banking authority over the service mix offered wholesale customers. In a business as competitive as this is, giving the manager closest to the customer ample rein is the most viable route to becoming number one. **MB**

Note: Copies of the studies upon which this article was based—The Wholesaler Quantitative Survey and Mortech90 (a study of the use of technology in the mortgage industry)—are available from:

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Jeff Lebowitz is president of Strategic Systems Partners, business and marketing consultants to the mortgage industry.

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ECONOMIC TRENDS

The homeownership rate in the United States in 1989 was a little below 64 percent, about the same as the rate in the preceding four years. However, as with many national statistics, the level and stability of the national homeownership rate masks a significant amount of variation in local markets.

Table 1 shows the distribution of homeownership rates among states in each region. The intervals of homeownership rates are set so that roughly one quarter of all states fall into each interval. Coincidentally, the top homeownership rate in the lowest interval is about the same as the national homeownership rate. This interval contains only 12 states. That means that 39 states (counting the District of Columbia as a state) have homeownership rates above the national average. The reason the national average is so much lower than the rates in most states is that many of the 12 states in the lowest interval are among the most populous. Consequently, the relatively low homeownership rates in the populous states tend to pull the national average down.

The regional distributions are interesting. One-third of the states in the Northeast have homeownership rates in the lowest interval (63.9 percent or less); but another one-third have rates in the highest interval (69.3 percent or more), making the Northeast the most diverse of the regions.

Homeownership rates in the South and the Midwest tend to be relatively high. In both regions, about two-thirds of the states have homeownership rates of 67.1 percent or more—well above the national average. At the lower end, only three states in the South, and one state in the Midwest have homeownership rates below the national average. Further, two of these three states in the South—the District of Columbia and Maryland—more or less border the Northeast.

TABLE 1

Distribution of Homeownership Rates Among States in Each Region

Region	Number of States with Homeownership Rates: 63.9 Percent or Less	64.0 Percent to 66.9 Percent	67.1 Percent to 68.8 Percent	69.3 Percent or More	Total Number of States in Each Region
Northeast	3	2	1	3	9
Midwest	1	3	6	2	12
South	3	3	5	6	17
West	5	5	1	2	13
U.S. Total	12	13	13	13	51

TABLE 2

Homeownership Rates for States and the District of Columbia (1987-89 Average)

Seven Highest				Seven Lowest			
State	Homeownership Rate [Percent]	Average Home Price [$ Thousands]	Ratio of Home Price to Per Capita Income	State	Homeownership Rate [Percent]	Average Home Price [$ Thousands]	Ratio of Home Price to Per Capita Income
West Virginia	73.5	80	6.4	District of Columbia	37.3	186	7.9
Maine	73.0	105	6.4	New York	51.7	151	7.4
Mississippi	72.8	77	6.5	Hawaii	52.9	180	9.8
Michigan	72.5	95	5.4	California	54.1	182	9.2
South Carolina	72.5	98	7.2	Nevada	54.2	140	7.4
Pennsylvania	72.2	95	5.5	Alaska	58.5	117	5.5
Oklahoma	71.5	100	7.1	Massachusetts	59.8	169	7.6
Average	72.6	93	6.4	Average	52.6	161	7.8

Homeownership rates tend to be relatively low in the West. Five states have rates below the national average, with five more having rates below 67 percent. Only three states—fewer than one-quarter of the states in the region—have rates more than 67 percent—a share well below any of the other regions.

To explore the source of differences in state homeownership rates, Table 2 shows the seven states with the highest homeownership rates and the seven states with the lowest homeownership rates. The simple average of the homeownership rate in the seven states with the highest rates is 72.6 percent; the average for the states with the lowest rates is only 52.6 percent.

Not surprising considering the tallies shown in Table 1, most of the states with the highest homeownership rates are located in the South, including West Virginia, Mississippi, South Carolina and Oklahoma. Two of the remaining states—Maine and Pennsylvania—are in the Northeast and one—Michigan—is in the Midwest. None of the top seven is in the West.

However, most of the states with the lowest rates are in the West—Hawaii, California, Nevada and Alaska. Two of the remaining states—New York and Massachusetts—are in the Northeast and one—the District of Columbia—is in the South.

Part of the explanation for differences between these two groups of states has to do with the fact that renting is more common in heavily urbanized areas for a variety of reasons, and many of the states with low homeownership rates are heavily urbanized. However, housing affordability, which also partly explains lower rates in urban areas generally, is clearly a factor in differences between these two groups of states.

The average home price of the seven low homeownership rate states—$161,000—is nearly 75 percent higher than the average home price of the seven high homeownership rate states—$93,000. Incomes are higher in the low homeownership rate states too, but not nearly enough to offset the differences in prices.

As the table shows, home prices averaged about 6½ times per capita income in the high homeownership states compared to around eight times in low homeownership states. At the extreme, prices are more than nine times income in California and Hawaii. With prices soaring above incomes in many states, it is not surprising to hear frequent cries of a continued affordability crisis. This crisis likely accounts for continued, relatively low homeownership rates in many large states.

Thomas M. Holloway
Senior Economist

VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
1990	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
MAR	10.26%	10.38%	9.22%	NA	8.53%	10.23%	8.53%	10.27%
APR	10.53	10.50	9.21	NA	8.60	10.37	8.55	10.37
MAY	10.49	10.54	9.28	NA	8.45	10.29	8.50	10.48
JUN	**NA**	**10.57**	**NA**	**NA**	**8.27**	**9.98**	**8.49**	**10.16**

SELECTED SECURITIES

		PRIME COMMERCIAL PAPER	U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	(3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
MAR	8.28%	8.28%	7.85%	8.35%	8.63%	8.59%	9.92%
APR	8.26	8.30	7.84	8.40	8.78	8.79	10.09
MAY	8.18	8.25	7.76	8.32	8.69	8.76	10.04
JUN	**8.29**	**8.14**	**7.63**	**8.10**	**8.40**	**8.48**	**9.85**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1990	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
MAR	9.87%	9.85%	9.84%	128	126	125
APR	10.01	9.94	9.94	122	115	115
MAY	9.99	9.93	9.92	123	117	116
JUN	**9.73**	**9.73**	**9.72**	**125**	**125**	**124**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC*				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments**	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
FEB	$1,690	$1,537	$239,853	$7,972	$4,922	$5,922	$5,676	$5,796	$3,680	$5,272
MAR	1,754	1,945	246,391	8,339	7,061	6,118	6,301	6,502	5,274	4,930
APR	1,568	1,705	252,236	7,790	7,211	10,441	5,719	5,687	1,667	4,477
MAY	**1,960**	**1,630**	**257,218**	**7,081**	**NA**	**NA**	**NA**	**NA**	**6,923**	**4,993**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,518	60,149	57,522
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
5 MONTH AVG.										
1990	1,726	1,806	---	7,788	6,699	7,625	6,029	6,120	4,515	4,984
1989	1,832	1,198	---	4,505	5,733	7,260	5,227	4,975	4,083	4,115
1988	2,658	2,244	---	3,654	2,358	4,833	2,792	2,206	3,982	3,616

*FHLMC year to date averages are one month behind.

**Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
FEB	1,488	1,196	292	1,297	1,041	256	224	293	581	390	170	298	442	387
MAR	1,307	1,031	276	1,232	969	263	139	280	520	368	145	249	453	385
APR	1,224	959	265	1,108	870	238	127	289	471	337	120	238	423	327
MAY	**1,207**	**932**	**275**	**1,057**	**843**	**214**	**129**	**266**	**486**	**326**	**124**	**220**	**408**	**305**
1989 TOTAL	1,376	1,059	318	1,338	998	340	179	266	536	396	179	252	505	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
5 MONTH AVG. (SAAR)														
1990	1,359	1,054	305	1,287	959	327	157	300	517	384	151	297	472	366
1989	1,433	1,096	337	1,361	1,014	347	210	277	560	386	197	262	512	391
1988	1,474	1,127	347	1,416	1,049	367	266	266	559	383	257	258	518	382

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
FEB	3,400	2,330	8.2	606	366	7.5
MAR	3,400	2,340	8.2	559	363	7.7
APR	3,330	2,660	9.6	530	362	8.4
MAY	**3,290**	**2,700**	**9.9**	**532**	**358**	**8.2**
1989 TOTAL	3,440	—	—	650	—	—
1988 TOTAL	3,594	—	—	676	—	—
5 MONTH AVG. (SAAR)						
1990	3,388	—	—	568	—	—
1989	3,466	—	—	629	—	—
1988	3,398	—	—	653	—	—

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1–Unit	2+ Units	Nonresidential
FEB	$313.2	$113.9	$18.4	$96.0
MAR	316.3	114.3	18.2	95.6
APR	312.4	110.1	18.7	94.2
MAY	**306.6**	**106.2**	**18.8**	**92.2**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
5 MONTH AVG. (SAAR)				
1990	311.5	110.9	18.4	94.4
1989	312.1	111.0	21.3	95.2
1988	315.1	112.1	21.3	94.2

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 DEC	$31,039	$5,555	$13,859	$10,951	$325	$3,706	$592	$1,371	$1,076	$333	$17,570	$11	$1,053	$12,970	$3,251
1990 JAN	34,012	9,802	11,023	12,578	247	3,228	866	884	777	377	17,223	149	765	12,928	3,139
FEB	30,279	9,867	9,938	10,129	27	3,042	682	804	768	551	14,041	202	883	9,469	3,320
MAR	**30,572**	**8,703**	**9,445**	**12,014**	**29**	**2,395**	**557**	**750**	**802**	**61**	**18,892**	**102**	**907**	**14,794**	**2,978**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
3 MONTH AVG. 1990	31,621	9,457	10,135	11,574	101	2,888	702	813	782	330	16,719	151	852	12,397	3,146
1989	26,271	5,257	12,612	8,041	61	2,643	282	1,433	540	179	10,492	74	1,578	7,243	1,461
1988	24,008	5,940	11,142	6526	79	2,312	234	1,362	386	176	14,155	54	1,967	10,437	1,466

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1990 FEB	131	83	16	31	103	$7,853	64	$4,076	18	$1,386	22	$2,391
MAR	158	99	18	41	113	8,769	68	4,442	19	1,538	26	2,789
APR	149	88	16	45	110	8,601	65	4,267	15	1,157	30	3,177
MAY	**155**	**93**	**17**	**45**	**112**	**8,919**	**65**	**4,382**	**15**	**1,236**	**32**	**3,301**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
5 MONTH AVG. 1990	144	88	17	39	111	8,636	66	4,319	17	1,344	28	2,973
1989	129	76	15	38	98	7,338	56	3,512	16	1,224	26	2,602
1988	152	87	16	49	104	7,468	56	3,357	17	1,246	31	2,865

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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SEPTEMBER 1990

MORTGAGE BANKING

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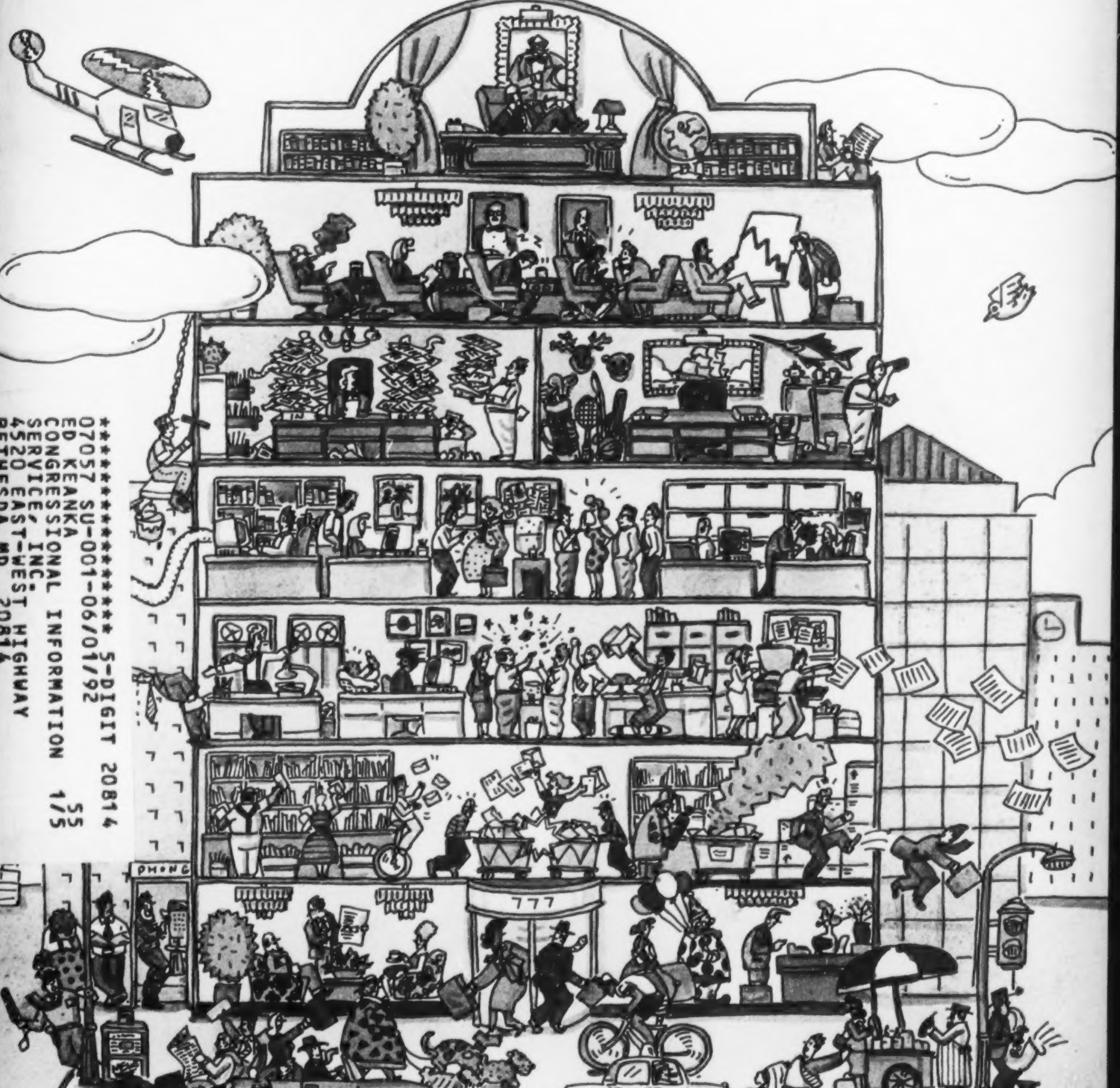

THE ANATOMY *of the* BUSINESS

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SEPTEMBER 1990 VOLUME 50 NUMBER 12

COVER:
Internal Management

If you look inside a mortgage company, it looks like almost any other workplace. Who would guess that what is being manufactured is the stuff of dreams. Getting people into houses does not require heavy machinery or robotics on an assembly line. Instead, it is people that move those dreams through the pipeline and deliver them into the mainstream of everyday life.

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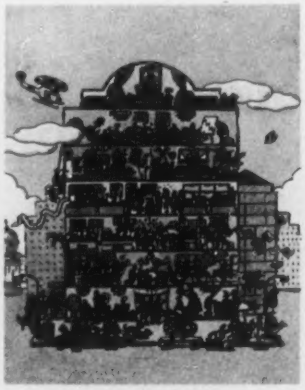
COVER ILLUSTRATION BY WANGDON LEE

PORTFOLIO

The Backbone

People are the backbone of the mortgage business—both people seeking a new home and people laboring to provide the money to buy it. That's a nice homey observation about the raw materials that drive the business, but it doesn't really say much more.

But, the way people really matter to those charged with running the business is by how efficiently they work. This, after all, remains a profoundly people-intensive way to make a profit—or not. In this issue devoted to examining the basic anatomy of the business, we see how people working harder and smarter can be the cure for what ails those toiling to survive in this industry.



People in the servicing department probably more aptly could be called the very muscle fiber of the operation. How efficiently they work spells the difference between anemic and healthy profits. KPMG Peat Marwick has been doing some basic research on the anatomy of several large servicing operations for four years now. They have sifted through the results just collected for last year and their findings are revealed in our cover story. Their diagnosis confirms that the one thing that separates the flabby servicers from those with peak muscle tone is the output they get from their people. There is just no way around these numbers: the low-cost servicers in their study averaged 919 loans serviced per full-time equivalent (FTE). On the other hand, high-cost servicers averaged a meager 472. Enough said?

This issue serves then as a tribute to those who have managed to create these lean, mean, people machines and to those striving to do so.

Janet Reilley Hewitt
Editor in Chief

EDITOR'S NOTE: In the July 1990 issue of *Mortgage Banking*, in the article titled "Discovering Commercial Mortgage Statistics," Table 1 should have shown the number of nonfarm, nonresidential, permanent mortgages originated in 1989 by savings and loans as 9,596.

COMING IN OCTOBER

The next issue will focus on the permanent structural changes now rocking the mortgage banking business. Our authors will try to size up the outlook for interest rates, appreciation, pricing, competition, servicing prices, budget reduction and profitability trends.

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IN
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SERVICING'S GREAT DIVIDE

The gap between high- and low-cost servicers remains wide, a new report card on the industry's biggest servicers shows. High-cost servicers suffer from many ailments, one of which is poor productivity.

Linda C. Simmons

This article is the first of a two-part series that examines mortgage servicing through a comprehensive study by KPMG Peat Marwick.

ILLUSTRATION BY WANGDON LEE

"Happy families are all alike;
every unhappy family is
unhappy in different ways"

Anna Karenina
Leo Tolstoy

In keeping with Leo Tolstoy's observation about life more than 100 years ago, KPMG Peat Marwick's 1989 Mortgage Servicing Performance Study (MSPS) found the same principles applying to mortgage servicing. The lower cost servicers were low cost for very similar reasons; the higher cost servicers experienced higher costs for very different reasons.

Furthermore, the mixture of results from the study still indicates that opportunities abound when servicers view both cost and profitability factors simultaneously.

For its fourth annual MSPS, KPMG Peat Marwick expanded the study's scope to include the key components of profitability as well as the components of servicing cost. Data collection was expanded in some areas, including portfolio characteristics, investor reporting, collections, foreclosures, and real estate owned (REO) costs. The number of participants grew, resulting in a database comprised of more than two million loans or $116 billion in loans serviced.

Servicing industry leaders from across the country submitted critical 1989 unit-cost and productivity, operating, profitability and balance-sheet data in early March. Stringent validation techniques were applied, and 19 servicing functions were analyzed, along with key portfolio, compensation and profitability statistics. Analytical results were provided to the participants in mid-May. Senior executives of participating firms met in early June to jointly review the results and to profile operational efficiencies. The information shared during the two days of discussion produced some enlightening insights on the results of the study.

Overall cost results

Core servicing cost, defined as the direct costs tied to each functional area within servicing, averaged $94 per loan. Of the 12 percent increase in the 1988 average core cost, nearly half is attributed to the change in capturing core costs in the REO area to more aptly reflect true costs incurred by servicers who also manage foreclosed property. The lower-cost servicers averaged $57 in core costs per loan, while the higher-cost servicers averaged $140 per loan. The relative distribution of core costs is reflected in Chart 1.

The total servicing cost per loan includes core costs, collateral losses, interest and other expenses resulting from bad loans plus allocated overhead. In contrast to the increase in core costs, the results for total servicing cost remained reasonably stable—averaging $144 versus 1988's average of $149. The contribution to total servicing cost from core costs increased from 56 percent to 65 percent; however, this increase was more than offset by the significant decrease in bad loan losses from 34 percent to 20 percent. A distribution of the different elements contributing to overall servicing costs is depicted in Chart 2.

Cost trends

The study's primary analytical focus was on the 19 servicing functional areas. Some overall, as well as some specific characteristics and patterns have emerged from the results of the last four years of the study. The following are some specific insights into the mortgage servicing operation derived from the current year's study.

The most significant cost increase came in the area of collections and foreclosures.

- Once again, loans serviced per full-time equivalent (FTE) proved to be a general predictor of core servicing cost performance. For the lower-cost study participants, loans serviced per FTE averaged 919; that is well above the average of 672 loans per FTE for all the participants in the study. Higher-cost servicers averaged 472 loans per FTE. The majority of repeat participants showed an increase in productivity, averaging 13 percent above their 1988 average.
- Consistent with prior years' studies, the overall size of each participant's portfolio was not a predictor of core servicing costs. The average portfolio size for lower-cost servicers (257,000 loans) did exceed the average portfolio size for all participants in the study in 175,000 loans. However, the higher-cost servicers averaged 166,000 loans in their loan portfolio.
- The most significant cost increase came in the area of collections and foreclosures, which includes bankruptcy and real estate owned functions. These costs rose 29 percent from the 1988 average. Interestingly, the lower-cost participants managed the expense of this key functional area up-front by spending twice as much, and using twice the FTEs in the collections area as in the foreclosure area. Higher-cost servicers spent twice as much on the foreclosure function as on the collections function.
- Overall turnover proved to be a reasonably good predictor of core cost performance. Surprisingly, a very low turnover rate had an adverse effect on core costs. Turnover by functional area was not a good predictor for functional core cost performance.
- While industry analysts have been predicting a growing trend toward servicing consolidation, a minimal amount of consolidation was detected in the 1989 study.

Lower cost vs. higher cost

As noted, lower-cost servicers share some similarities, including:

- a higher concentration of GNMA loans in their portfolios, with GNMA concentrations averaging 46 percent versus 20 percent for the remaining participants;

Chart 1

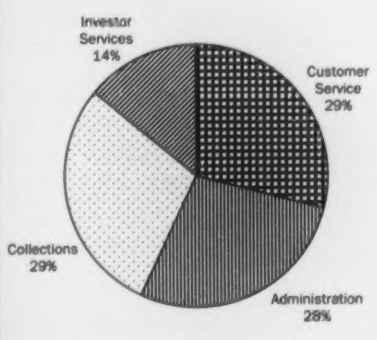


Chart 2

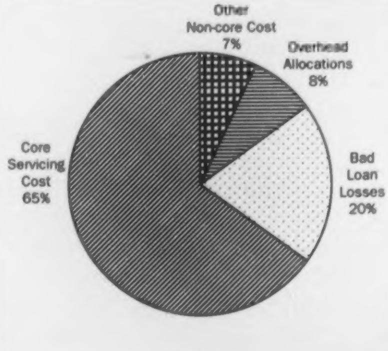
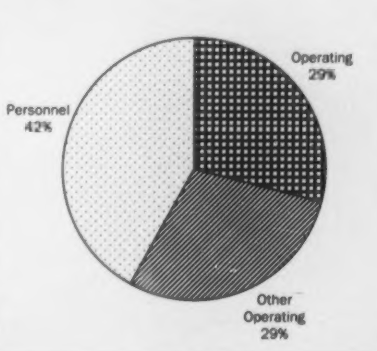


Chart 3



- a higher concentration of fixed-rate loans than the remaining participants, 94 percent versus 79 percent, respectively;
- in general, a larger amount of net growth within each portfolio, whereby the higher-cost servicers experienced little or negative growth; and
- a lower salary cost per FTE. Salary and other personnel costs had a significant impact on overall costs as 40 percent of core costs were personnel costs. (This is depicted in Chart 3.)

Like Tolstoy's unhappy families, the study's higher cost servicers shared few characteristics. However, certain features did emerge as contributing to the higher costs experienced by these servicers. They included:

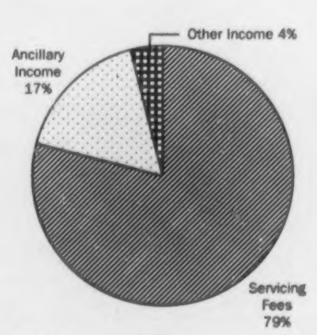
- a higher concentration of loans in one or two states that did not provide lower cost opportunities for these servicers;
- use of either monthly billings or coupon books, or both (while lower-cost servicers used coupon books almost exclusively);
- portfolios dominated by conventional fixed-rate, ARM, and GNMA product, respectively for the top three high-cost servicers;
- no confirmed pattern of above-average prepayments, delinquencies or foreclosures;
- somewhat higher salaries per FTE, but more FTEs in general.

The three highest-cost servicers had their portfolios serviced by a service bureau, a modified in-house service bureau, and a custom in-house system indicating no connection that could be automatically linked to higher servicing costs.

One characteristic shared by most higher-cost servicers was a substantial parent company overhead allocation, either in the form of data processing costs or management fees. A larger expense allocation for data processing increased the core servicing cost, while the higher management fees increased the total servicing cost.

The study for 1989 showed that total servicing revenues averaged 48 basis points on an average loan balance of $64,000.

Chart 4



Profitability trends

The study for 1989 showed that total servicing revenues averaged 48 basis points on an average loan balance of $64,000. As expected, servicing fees dominated the revenue area, accounting for 79 percent of gross revenues. Ancillary income, including late charges, insurance fees, assumption fees, and the like, contributed 17 percent of gross revenues, or $49 per loan. Chart 4 provides a breakout of these servicing-related revenue sources.

There was, however, no clear relationship between revenues generated from servicing and net income. There was also no relationship between gross revenues and core cost performance. Because this was the first year profitability data was collected, we were unable to discern whether this was a continuing trend or not.

Emerging Issues

This study is a peer analysis that bases its results on cost comparisons to a comprehensive mortgage servicing performance analysis. It is still evolving, and we encourage management involvement at all levels and areas. The study will continue to focus on current industry concerns including emerging tax issues, and accounting issues involving purchased and excess servicing.

As our understanding of servicing's cost components grows, so does our list of questions. While maintaining the consistency of data is an ongoing challenge, study participants are to be congratulated for their diligence in assisting us in molding their data into comparable form. Perhaps the more difficult part of the study is asking enough questions, particularly in those areas experiencing rising costs or declining profitability. For example, does the increase in the collections and foreclosure cost area complement the decline in industry delinquency and foreclosure rates? Or, does it serve as a predictor of future rising delinquency and foreclosure rates?

In Part II of this article (scheduled to appear in the October issue), we will discuss additional analyses beyond cost performance in an attempt to address some of these issues. Statistically significant relationships, derived from four year's worth of collected data, will help promote a further understanding of servicing performance.

Study participants have used the results of these annual analyses to conduct yearly internal management reviews of their servicing operation and to get an updated view of their servicing department's performance relative to the best in the industry. In the future, study participants will be provided updated information and ongoing analyses to better position their servicing department to take advantage of emerging trends and issues. This data should help other servicing managers share in the solutions and further cultivate ideas that are available from the most successful servicers in the industry. **MB**

Linda C. Simmons is a principal in KPMG Peat Marwick's Washington, D.C. office. Dr. Simmons is an active participant in the firm's national mortgage banking practice. The 1990 Mortgage Servicing Performance Study will be conducted by the Washington office.

ECONOMIC TRENDS

As we enter the 1990s, few would deny that housing conditions in the U.S. are among the best, if not the best, in the world. Still, the decade began with fears about the outlook for new construction, trends in home prices, the viability of financial institutions, and the persistence of affordability problems. Many of these issues are addressed in a new study by the Joint Center for Housing Studies of Harvard University entitled *The State of the Nation's Housing 1990.*

The study begins by addressing the widely recognized impact of demographic changes on housing demand. The baby boom generation—those individuals born between 1946 and 1964—boosted the rate of population growth in the U.S. significantly in the 1950s and early 1960s. Since then, the population growth rate has slowed and is expected to continue to do so in the 1990s. The formation of the population into households, which is very sensitive to the age-distribution of the population, has followed predictable patterns. When the bulk of the baby boomers hit their twenties in the 1970s, household formations soared, and, along with this surge in formations, new construction surged too. In the 1990s, household formations will slow because many baby boomers have already formed households and the subsequent generation is much smaller. Consequently, recognizing that new construction equals the sum of new household formations, changes in the number of vacant units, and replacements of worn-out units, it is clear that the pace of new construction is almost certain to slow.

Table 1 shows the sources of new construction demand. During the 1970s, household formations were so strong that new construction (excluding mobile homes) averaged nearly 1.8 million units per year. As formations slowed, so did the pace of construction activity. In the 1980s, new construction of structures amounted to 1.50 million units per year. In the early 1990s, activity is expected to slow to around 1.37 million units per year; then to drop to around 1.27 million units in the late 1990s.

However, the composition of these units is likely to change. Units are likely to be larger and have more amenities as the baby boomers move up from starter homes. Consequently, construction spending is likely to hold its own in the face of a decreasing number of units. The Joint Center notes: "Market forces point to steady growth of tradeup demand, with increases in the size and quality of new homes built countering declines in the number of units constructed." The implication is that the trend toward the construction of fewer units may not impact mortgage lending volume adversely.

TABLE 1

Sources of New Construction Demand
[Thousands of Units, Annual Averages]

	Total New Construction		Sources of Demand		
Period	**Structures**	**Mobile Homes**	**Household Formations**	**Change in Vacancies**	**Replacement of Worn-out Units**
1970-1980	1,786	367	1,604	122	427
1980-1990	1,500	249	1,275	306	168
1990-1995	1,371	200	1,223	126	222
1995-2000	1,269	200	1,090	144	235

Source: Joint Center for Housing Studies, Harvard University

The Joint Center also finds no evidence to support the claim that reduced demographic demand will result in falling home prices, as some have predicted. The study concludes: "...Housing prices are unlikely to ease during the 1990s....Today's homeowners have little reason to worry." Further, because homes are generally highly leveraged (i.e., homeowners borrow to cover most of the purchase price), the study demonstrates that homeownership remains one of the best vehicles for wealth accumulation and financial security for most households. Continued modest home price appreciation will ensure this role continues into the 1990s.

Unfortunately, affordability problems remain. Those who are not homeowners currently face the difficulty of overcoming cumulative price increases in the 1970s and much of the 1980s that drove home prices to levels beyond the means of most renters. Because homeownership is so vital to wealth accumulation, locked-out would-be buyers face a dilemma. The Joint Center notes: "This is the vicious circle would-be buyers face: lack of savings and wealth prevent them from securing a home, the very asset that has proven to be the best source of wealth accumulation for the vast majority of American households." Because home prices are not likely to decline, the Joint Center argues that "there is little reason to believe that the affordability problems of the past two decades will quickly fade away in the 1990s."

The study suggests that only 13.6 percent of the 29 million renters nationwide could qualify for a mortgage to buy a typical starter home. Further, of the 11 million young renter households—defined as households headed by individuals aged 25 to 34—only 12 percent had both adequate savings to make the necessary down payment on a typical starter home and the income to meet mortgage payments. The down payment was clearly the bigger problem. Fully 81 percent of these households could not meet the down payment requirement. In short, the Joint Center study makes it clear that housing affordability remains a major obstacle to homeownership in the U.S.

Thomas M. Holloway
Senior Economist

VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
1990	FHA New Homes[1]	CONVENTIONAL[2] FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
APR	10.53%	10.50%	9.21%	NA	8.60%	10.37%	8.55%	10.37%
MAY	10.49	10.54	9.28	NA	8.45	10.29	8.59	10.48
JUN	10.21	10.57	9.33	NA	8.27	9.98	8.49	10.16
JULY	**NA**	**NA**	**NA**	**NA**	**8.14**	**9.88**	**8.43**	**10.04**

SELECTED SECURITIES

			U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	PRIME COMMERCIAL PAPER (3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
APR	8.26%	8.30%	7.84%	8.40%	8.78%	8.79%	10.09%
MAY	8.18	8.25	7.76	8.32	8.69	8.76	10.04
JUN	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JULY	**8.15**	**7.99**	**7.52**	**7.94**	**8.26**	**8.47**	**9.96**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1990	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
APR	10.01%	9.94%	9.94%	122	115	115
MAY	9.99	9.93	9.92	123	117	116
JUN	9.73	9.73	9.72	125	125	124
JULY	**9.66**	**9.66**	**9.66**	**119**	**119**	**119**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC*				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments**	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
MAR	$1,754	$1,945	$246,391	$8,339	$7,061	$6,118	$6,301	$6,502	$5,274	$4,930
APR	1,568	1,705	252,236	7,790	7,211	10,441	5,719	5,687	1,667	4,477
MAY	1,960	1,630	257,218	7,081	5,093	8,502	6,064	5,792	6,923	4,993
JUN	**2,089**	**1,802**	**263,330**	**8,266**	**NA**	**NA**	**NA**	**NA**	**6,851**	**5,674**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,518	60,149	57,522
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
6 MONTH AVG. 1990	1,787	1,806	---	7,868	6,378	7,801	6,037	6,308	4,905	5,099
1989	1,955	1,309	—	4,778	5,633	6,845	5,210	4,875	3,947	4,119
1988	2,578	2,265	---	4,082	2,429	5,148	2,808	2,230	4,146	3,942

*FHLMC year to date averages are one month behind.

**Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
APR	1,216	951	265	1,108	870	238	124	284	469	339	120	238	423	327
MAY	1,206	933	273	1,065	853	212	127	256	487	336	124	218	410	313
JUN	1,179	922	257	1,108	844	264	114	238	534	293	121	224	428	335
JULY	**1,148**	**905**	**243**	**1,079**	**834**	**245**	**108**	**225**	**498**	**317**	**108**	**227**	**430**	**314**
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	506	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
7 MONTH AVG. (SAAR)														
1990	1,302	1,013	289	1,233	927	306	143	278	516	363	140	276	460	356
1989	1,429	1,084	345	1,344	998	346	201	272	555	401	189	254	508	393
1988	1,472	1,129	343	1,429	1,055	374	261	268	563	380	250	261	530	389

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
MAR	3,400	2,340	8.2	558	363	7.7
APR	3,330	2,660	9.6	526	363	8.4
MAY	3,300	2,740	9.9	538	358	8.2
JUN	**3,340**	**2,640**	**9.5**	**581**	**352**	**7.5**
1989 TOTAL	3,440	—	—	650	—	—
1988 TOTAL	3,594	—	—	676	—	—
6 MONTH AVG. (SAAR)						
1990	3,382	—	—	570	—	—
1989	3,443	—	—	632	—	—
1988	3,448	—	—	665	—	—

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[a]	1−Unit	2+ Units	Nonresidential
MAR	$316.3	$114.3	$18.2	$95.6
APR	313.8	109.7	18.7	94.7
MAY	309.0	105.7	19.0	93.5
JUN	**308.9**	**102.0**	**19.0**	**97.2**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
6 MONTH AVG. (SAAR)				
1990	311.7	109.3	18.6	95.2
1989	313.6	111.7	21.3	95.7
1988	314.8	111.8	21.7	93.[illegible]

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 DEC	$31,039	$5,555	$13,859	$10,951	$325	$3,706	$592	$1,371	$1,076	$333	$17,570	$11	$1,053	$12,970	$3,251
1990 JAN	34,012	9,802	11,023	12,578	247	3,228	866	884	777	377	17,223	149	765	12,928	3,139
FEB	30,279	9,867	9,938	10,129	27	3,042	682	804	768	551	14,041	202	883	9,469	3,320
MAR	**30,572**	**8,703**	**9,445**	**12,014**	**29**	**2,395**	**557**	**750**	**802**	**61**	**18,892**	**102**	**907**	**14,794**	**2,978**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
3 MONTH AVG. 1990	31,621	9,457	10,135	11,574	101	2,888	702	813	782	330	16,719	151	852	12,397	3,146
1989	26,271	5,257	12,612	8,041	61	2,643	282	1,433	540	179	10,492	74	1,578	7,243	1,461
1988	24,008	5,940	11,142	6526	79	2,312	234	1,362	386	176	14,155	54	1,967	10,437	1,466

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1990 MAR	158	99	18	41	113	$8,769	68	$4,442	19	$1,538	26	$2,789
APR	149	88	16	45	110	8,601	65	4,267	15	1,157	30	3,177
MAY	155	93	17	45	112	8,919	65	4,382	15	1,236	32	3,301
JUN	**150**	**90**	**17**	**43**	**113**	**9,021**	**64**	**4,289**	**16**	**1,309**	**33**	**3,423**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
6 MONTH AVG. 1990	145	88	17	40	112	8,701	66	4,314	17	1,339	29	3,048
1989	134	79	15	40	99	7,473	56	3,555	16	1,198	27	2,720
1988	155	87	17	51	106	7,634	55	3,298	17	1,240	34	3,096

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.

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OCTOBER 1990

MORTGAGE BANKING

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The Winds of Change

Lenders are being buffeted by change in just about every corner of the mortgage business. Competitive pressures, the smell of recession in the wind and stalled appreciation in some bellwether markets has mortgage lenders wondering about the future. But the future is difficult to forecast because the industry is going through the very eye of a hurricane now that will leave behind changes that will reshape the business permanently.

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PORTFOLIO

Changing Times

The Middle East has shaken up the outlook—there's no question. But if that were not on the front pages, there would be plenty of other news making the economy's prospects shaky. The housing markets are another story altogether—or rather several stories. In some regions, we hear from some strong originators that the year is pulling ahead of last year in terms of production numbers. In other places, the news is that business is flat or hurting.

But the news that the business cycle is alive and well is not really big news. And the inflation hit caused by huge jumps in oil prices just makes an already shaky, debt-burdened economy more wobbly. Again, nothing new there.

It is the mortgage industry itself that is undergoing headline-making changes. The RTC is now redistributing the wealth long held inside local and regional thrifts. New players are stepping up to the counter to give those assets a new home. So, on this beat, we believe one of the really big headlines of the year is that a mortgage insurer has finally crossed the line into the servicing business. Those deep pockets of General Electric Mortgage Capital Corporation have finally been tapped, as many have long speculated they would be, to enter the servicing business. With servicing prices at bargain basement levels, we should be in for a series of headlines in the coming months on a cadre of new, well-heeled, servicing novices.

New approaches to production are also giving the traditionalists a run for their money. The talk here is about new "distribution channels." Will explicit Realtor-mortgage lender alliances work? Is telemarketing mortgages a viable business plan? It's too early to tell, but all eyes are on the pioneers.

Janet Reilley Hewitt
Editor in Chief

Editor's Note: An article in the August issue titled "Wholesale Competition" was based on the results of a study co-sponsored by Mortgage Dynamics, Inc. The article omitted mentioning that MDI's managing directors, Mary Bruce Batte and Dan Measell, conceived the study and were instrumental in its actual development and design.

COMING IN NOVEMBER

Next month we will explore different approaches to bringing in mortgage business. The subject is marketing and how lenders are using it to their advantage.

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Winds of Change

The business of mortgage banking will be done differently in the future. Not much time is left to change the sails, but here's a look at which way the wind is blowing.

Fred Portner

The marketplace is lecturing to those of us left in the mortgage business. If you were to pause and take a moment to listen, this is what you would hear: "Say hello to the person on your left and your right. At the end of the year, two of you will be gone."

I wonder if the marketplace's lecture to us has our full attention?

The mortgage banking industry is undergoing the same permanent structural change as the rest of the financial service business. And as we already know, bankers and thrift managers are seeing the competitors on their right and on their left—or themselves—disappear.

Consolidation is one of the inevitable results of the rationalization of any fragmented business. But consolidation and the elimination of weaker firms is not the only structural change being faced today in mortgage banking. A few other key issues are exacerbating the pressures of this transition. These other issues include price erosion, unchecked cost escalation, meager investment in technology and inadequate management capabilities.

The inevitable companion to industry consolidation is intensified price competition. The traditionally high margins of the industry attracted numerous additional competitors in the 1980s. This additional competition, plus the end of the 1980s demand bubble caused by refinancings, has resulted in a marketshare struggle carried out at least in significant part through price competition. The net result is likely to be a permanent reduction in effective prices.

In terms of the issue of unchecked cost escalation, historically we have not been a cost-conscious industry, but rather volume-conscious. As a result, unit costs have continued to escalate, even in the face of declining demand. We haven't succeeded in adjusting our operations quickly enough to the new realities of production.

To further try the hand of the industry's leaders, this business has not made the most of available technology. Historically, we have spent little money on technology, or worse—where we have spent lavishly, the results have been dismal. We are an industry crying out for help in improving productivity, yet have little positive experience in applying the tools of technology to assist us.

Finally, industries in transition demand much deeper and broader management capabilities than do stable industries. The breadth of management capabilities in mortgage banking is thin relative to the current challenges being faced.

Furthermore, the transition from a fragmented industry is being abetted by pressures from regulators and the banking and thrift industries' performance. These pressures will further alter the competitive landscape.

The impact of the changing roles of thrifts and banks in the competitive landscape is significant. On balance, the mortgage industry is trading out one substantial competitor—thrifts— for another—banks. This new competitor, however, is better capitalized, managerially deeper, and technologically more resourceful. There is no question that thrifts must change their posture toward mortgage lending/banking. Growth constraints created by tougher capital requirements are dampening the often irrational pricing practices of the past, and, therefore, throttling unbridled production strategies. Rules relative to capitalized servicing are reducing thrifts' aggressiveness toward purchased servicing.

As thrifts reduce their aggressiveness, commercial banks have compelling reasons to accelerate their mortgage banking strategies. The new risk-based capital regulations encourage banks to hold residential mortgage assets. In addition, there is generally a scarcity of other attractive lending opportunities currently available. Finally, banks are believers in

ILLUSTRATION BY STEVE McCRACKEN

building retail relationships, with mortgage lending providing a key vehicle for doing that. It is true that, as with thrifts, the new capital regulations discourage purchased servicing by banks, but only in extreme capital situations. Most large banks have significant room for additional goodwill in the form of purchased servicing.

The entry of major new competitors during any wide industry structural transition usually results in permanent changes to the competitive environment or, in other words, how the business is actually done. Although slow to evolve, this is also happening in mortgage banking.

The entry of heavily capitalized competitors such as Sears Mortgage Corporation, Citicorp Mortgage, Inc. and Prudential Home Mortgage accelerated the development of private securitization, which in turn redefined the pricing and documentation requirements for the largest segment of the industry—low-LTV, conventional lending. Technology investment has accelerated, resulting, for example, in 15-minute loan approvals (using artificial intelligence), effective remote processing and, perhaps, significant changes in the scale economics in servicing.

Another way the competitive environment has changed is that new delivery channels have been developed. Retail branch production is but one way to reach consumers, and is probably not the most efficient in many cases. Direct mail/telemarketing is proving viable, Realtor-builder/lending partnerships have flourished and the wholesaler-broker distribution combination has become a dominant force in several of the largest markets.

So, without a doubt, the way we conduct the business is changing. And it will continue to change, pressured by the new competitors with new ideas and a lack of historical bias and culture to overcome.

Transitions are painful

Make no mistake about it, structural transitions are not fun for most people in any endeavor. A whole way of working and living is being upset. Uncertainty is heightened, positions and, indeed, self-esteem and confidence are threatened. Resistance is the first and natural response.

Unfortunately, the characteristics of our industry are not well suited to ease the transition and the attendant natural threats to its work force. Mortgage banking is not a business with high research and development (R & D) expenditures. Typically, we do not invest a lot in new ideas. As a result, we are not accustomed to regularly trying new ideas. Any expenditures in R & D are an incremental cost to us, at a time when cost pressures are already substantial.

The message for our industry is not that the sky is falling, or that all is lost.

Existing mortgage banking management teams have little experience in testing or implementing alternative solutions. Merely learning how to go about investigating new alternatives, while still managing current business, is a significant challenge; one which typically results in pushing the whole issue of addressing needed changes down the priority ladder.

The key resources present within the industry today are not the right ones to lead the changes. Real consumer marketing talent is very thin within the industry and deep, practical technology and process-management talent has not been acquired. As a result, the two key areas of expertise—marketing and technology—are not available in quantity to provide the conceptual leadership necessary for the current industry-wide transition.

The net result is regrettable, but predictable. There is a strong, natural resistance to change and a lack of clarity about the solutions or how to get them implemented. The actions taken, therefore, tend to be traditional, short-sighted, short-lived solutions to the issues—cut staff, shave commissions, price competitively and pray for greater volume, or hire consultants and relinquish responsibility for the problems to them. However, this structural transition is a strategic issue we cannot run or hide from. It must be met head-on, with an open mind and a commitment to change

Learning from other industries

If mortgage banking's managers can't hide, then where can we look to gain perspective on the challenges they now face and, more importantly, find the logical solutions? Surely, mortgage banking, and financial services in general, are not the only fragmented industries that have undergone structural change. Several industries have, in fact, experienced similar changes during the past two decades that mortgage banking is now facing. Those industries include airlines, trucking, investment banking and the grocery business.

While the exact nature and results of each of these industry-wide consolidations was different, there are some critical similarities that provide relatively unambiguous insights into what we should expect in the mortgage banking industry.

The outcomes of those other industry transitions produced fewer competitors. Not just a handful of competitors resulted, but it typically produced a bifurcation of the business between a few, very large, competitors and many very small players, with a dwindling of mid-sized competition. This is understandable, as the two groups select the specific basis on which they will compete. Big players capitalize on scale economics and technological and marketing sophistication to differentiate themselves, while small players focus on speed, flexibility and an absence of overhead. Mid-sized players tend not to be able to win against either of the strategies, with the marketplace becoming less and less tolerant of simple "me-too" competition.

As these other industries have shown, transitions also produce better cost economics. It is axiomatic that cost structures change, that is, improve, dramatically as industries consolidate. The cause of the improvement, however, is not just size.

In fact, it rarely is. But rather it is usually fundamental changes in the entire delivery system for the product. Fresh eyes, not blinded by history, literally dismantle the parts of the business and then reconstruct them, using superior marketing, technology and process management skills. But, however obtained, unit costs are improved significantly through the structural consolidation of the industry.

Another side effect of these industry-wide transitions is a crisper focus—"All things to all people," and "volume of any kind from any price" are no longer valid management principles. The winners clearly and carefully select what product, geography and type of distribution segments in the business that they want to compete. They also decide specifically how they will compete. The focused competition stands a chance of winning, the non-focused competitor almost surely vanishes.

The final by-product yielded by the structural change that reshaped those other industries was frequently different management. Over time, any industry attracts, develops and maintains the kind of managers needed to be successful. As the rules of the game change, so do the management requirements. Structural consolidations fundamentally change the rules of the game and the concomitant managerial requirements. More often than not, the existing managements find it difficult or impossible to learn or adjust. The necessary knowledge must be imported from outside the industry, and the existing culture must be modified to assimilate effectively this new perspective and style.

The sky isn't falling

The message for our industry is not that the sky is falling, or that all is lost. There will continue to be a very viable mortgage banking industry. Demand for mortgage loans will continue, albeit subject to cyclical pressures. Therefore, there must be someone to deliver the service. And if demand is present, the economics of the business will adjust over time to be acceptable for the better competitors.

> *One undebatable conclusion is that unit costs of production must be reduced.*

Clearly the business must change to remain viable. One undebatable conclusion is that unit costs of production must be reduced. Price increases aren't likely and increased volumes can't be depended on to bail the industry out. The profit margin structure of mortgage production has worsened intolerably for the average production operation.

Fifteen years ago, production overages were normal, one could reasonably bank on marketing profits, and the value of servicing was not yet recognized in the marketplace. Some 300 basis points in total revenues were reasonable to expect (See Chart 1). Costs were contained, principally by a lack of intensive competition. The net results were often branches with direct production profits and very strong "full economic" profit margins.

Now that is no longer the case. For the typical firm, production is a net cost and a substantial one. It is not unusual to see a 70 basis point net direct cost of production. Marketing profits have disappeared (unless the company manages its pipeline uncovered), and despite an increase in the value of servicing, the typical firm is fortunate to break even on a full economic basis. Moreover, in the current environment with servicing values temporarily depressed, the full economic value of production may even be negative. Firms must either adapt in various ways to reduce their unit costs or suffer a gradual liquidation of their equity bases.

Another way that the business must adapt is by finding a way to reach the consumer more efficiently and effectively. The historic, ubiquitous, branch-based delivery system, with essentially no formal consumer marketing support, must give way to more and better ways to reach the consumer. Two hundred basis points to produce a loan in a branch is not tolerable.

Depending upon an intermediary, such as a builder or Realtor, to generate every piece of business almost guarantees a price-based, high cost-of-acquisition production approach. As more home buyers in the 1990s move-up and become more knowledgeable borrowers, the need to deal through an intermediary diminishes. Efficient direct marketing becomes a viable alternative to a singular reliance on branch-based production.

Today's mortgage lenders must also rationalize their documentation standards. Documentation requirements in large measure dictate not only the cost structure of the business, but also relative access to major segments of local markets. Consequently, this aspect of production influences unit costs from two perspectives—branch scale and individual functional costs.

Traditionally, mortgage bankers adhered to the documentation requirements of their principal investors—the agencies—accepting the requirements as merely a cost of doing business. Now, however, it is a cost that must be challenged at every turn. Alternative investors with documentation levels better rationalized by quality of credit and borrower, permit streamlined cost of production and greater customer service. Failure to challenge documentation requirements reasonably, and make active trade-offs between the depth of documentation and its cost, ultimately will take its toll on indi-

Chart 1

Production Expenses and Revenues
1975 versus 1990

(in basis points)	**1975 ±**	**1990**
Revenues		
Origination revenues	1.50%	1.30%
Servicing value	1.00	1.50
Marketing profits	.50	0.00
Total revenues	3.00%	2.80%
Expenses		
Direct branch cost	1.30%	2.00%
Production support/admin	.15	.30
Corporate overhead	.25	.50
Total expenses	1.70%	2.80%
Net revenue	1.30%	0.00
Pretax profit margin	43.00%	0.00

vidual competitors in terms of cost and marketshare positions, thus almost guaranteeing weak or non-existent profitability.

Documentation standards should be completely adjusted to meet the varied risks posed by product and type of customer segment, rather than blindly applied across the business.

If there is one key to future success that all mortgage bankers can act on relatively quickly, it is the concept of focus. Understanding what customers, geographic markets and what specific products the firm has, and then structuring the entire firm to focus on these areas, is critical to succeeding in a consolidating industry.

It requires thinking and courage to make tough personnel decisions, but it doesn't usually require extensive investment. Most mortgage bankers know "where their bread is buttered." Getting rid of areas that do not contribute to the overall success of the firm is not is a major step toward survival.

Another principle that needs to be embraced by managers that want to prosper in the new competitive environment is the co-equal management of all pieces of the business. Mortgage banks are typically production-driven companies. Sales management dominates. If we are to survive, operations and secondary marketing must assume co-equal influence and attention. Integrated mortgage bankers will not survive without secondary marketing capabilities that are well beyond merely being able to sell product to the agencies or conduits. Nor will they be able to turn sales into profits without skills in the operations area.

Change creates opportunities

Change is not necessarily bad. Change always creates as many opportunities as threats. The rules for success are merely altered. The seemingly paradoxical behavior of individual mortgage banks in recent times reinforces the dual-edge condition present in today's mortgage lending business environment.

In the area of retail production, for example, we have seen Lomas Mortgage USA, Dallas, close or sell off its retail branch network, concluding that it cannot make the business adequately profitable. The industry has also witnessed numerous other mortgage banks either leave the retail business completely, reduce their networks, or switch to wholesale production due to the apparent high cost of retail production. Yet other competitors, such as Norwest Mortgage, Inc., Des Moines and Countrywide Funding Corporation, Pasadena, are aggressively, or at least selectively, expanding their retail networks. Why? How can the business look so bad to some competitors and so good to others?

The ultimate winners and losers in the servicing business are beginning to emerge.

A second paradox in retail production is the simultaneous exodus of firms with large branch networks and the tremendous expansion of mortgage brokerage operations. What is it in the economics of the production business that makes the origination business attractive to prospective brokers and yet negative to branch network-based competitors?

In another aspect of the business, servicing values are down, markedly. Therefore, servicing is not attractive, or is it? Obviously, it depends on whether you are selling or buying. For the firms with a large servicing portfolios that are neither buying or selling in significant quantities, the situation is neutral. The real economic value of servicing has not changed appreciably.

For the originator who must rely upon servicing-released sales to cover production costs, the changes taking place are a catastrophe. The cash value of his product has declined as much as 30 percent in recent months. However, for the firm considering building or expanding its servicing business, the situation is perhaps singularly attractive. Potential returns on new servicing acquisitions are the highest they have been for more than 10 years. This is a situation that may not be repeated for some time. It is a critical period for building market position in the servicing business.

Is this paradoxical competitive behavior? Absolutely. But it is entirely rational. The structural dynamics are creating enormous opportunities as well as hardships. The competitive dynamics at work here will help explain the paradoxical behavior.

Traditional branch operations are indeed largely unprofitable. Such operations typically entail small average-branch size, low productivity and products sold at razor-thin commodity-like margins. Lomas and Nettleton, to use that example, was unable to change its equation sufficiently to make a difference. It validated the unacceptable profit dynamics of the traditional branch. There is a need to change the delivery system to make retail branch unit costs acceptable.

Presumably, Norwest, a company that is pursuing a branch building strategy, will do so by concentrating on high-balance or at least low-documentation credits, enabling its branches to build larger volumes with lower unit costs, fundamentally altering the branch economics. It is the same strategy the major thrifts have deployed successfully for years.

Countrywide has chosen a different, yet apparently successful strategy. It has focused on the high cost of originators, reducing or eliminating this cost, accepting lower average-branch volume, but producing this volume at a lower cost. They have also substituted direct mail marketing for the loan originator. Whether this combination of strategies is defendable over the long term is not clear, but it has helped Countrywide bridge a perilous period in the business.

How can mortgage brokers make it when branch networks can't? Relative cost advantage is not the answer. The combined cost of the wholesaler and mortgage broker or correspondent is almost certainly greater than that of the branch network. Then what is fueling this transition from retail branch networks to mortgage brokers?

One answer is a willingness by brokers and wholesalers to squeeze more of the profit margin out of the business to win production. Branch network-based competitors still largely price their products directly off the secondary market, without adjusting prices for servicing value. Wholesalers readily price their product to their customers with either an explicit or implicit servicing-release fee. It is implicit if it shows up as a lower net price to mortgage brokers or explicit if servicing-release fees are quoted separately. In either case, the net result is a lower "street" price for the originator than that which the typical branch network can quote. Business looks good to the wholesale originator, terrible to the branch network.

The other answer is probably just as important. Mortgage brokers tend to win in head-to-head competition with branch originators because they are better and more seasoned marketers. Typically, they have established clientele who come to them because of service as much as price. Despite the focus on price competition, mortgage production is still as much service-based as it is price-based. The proliferation of mortgage brokers reinforces the importance of customer service in the equation for successful retail production.

Finally, in the area of servicing the dynamics are reasonably clear. The following configuration of: excess supply in the form of RTC-controlled servicing, which ultimately will be placed back in private hands; plus the loss of traditional competitors (the thrifts); and the change in capital regulations that dissuade purchased servicing; has resulted in a temporary buyers' market. Clearly, the situation is temporary, since the true economic value of servicing hasn't changed materially.

The ultimate winners and losers in the servicing business are beginning to emerge. However, some of the more logical long-term winners have yet to buy into the business. Some of the logical candidates to emerge as buyers of servicing and potential buyers with special reasons not to buy into the servicing business, warrant a brief discussion.

Public companies are disadvantaged. Servicing is a wonderful cash flow business. It is only a fair reported earnings business under typical purchased servicing prices. Mutual insurance companies are naturals, given the lack of focus on reported earnings, cash reserve buildup opportunity, plus the opportunity to acquire attractive assets in large quantities and control the quality of asset servicing. Private ventures to buy servicing rights are attractive. Tax-sheltered investments are possible. Banks should be willing to provide the necessary leverage, having a predictable cash flow as collateral.

The structural pressures in the industry will continue for some time. The restructuring of the industry is nowhere near completion.

Scale economics may ultimately prove a significant differentiator among competitors. But to date, that has not been the case. Therefore, it's not likely that a handful of firms will control a majority of the servicing. For portfolios larger than say $4 to $5 billion, servicing unit costs have been largely a function of servicing location (labor costs/quality), portfolio mix and operational management skill, not size.

Sidestepping the threats

The structural pressures in the industry will continue for some time. The restructuring of the industry is nowhere near completion. In order to transform threats into potential opportunities, there are several critical issues that each firm must sort out and incorporate explicitly into its strategy.

The starting point to develop a viable survival strategy is understanding clearly the competitive environment. Banks, thrifts, independent mortgage banks and mortgage brokers are all in a state of flux. Each has some relative strengths it can exploit, as well as some particular vulnerabilities. Since it is no longer feasible to be all things to all people, it is critical to determine explicitly the answers to three specific questions.

What are your comparative strengths—and weaknesses—relative to each type of competitor? Which market segments are ones where you can have a relative advantage or the places where your relative advantages can be best applied? How best can you apply your relative advantages to win and defend marketshare?

Much is written about competitive strategies, and most of it is conceptually correct. Unfortunately, in the press of daily management, most of it is forgotten or ignored. Ignoring the incisive development of a competitive strategy now may be tantamount to failure.

Theorists would lead us to believe that, as a paper intensive business and, therefore, subject to scale economics and technology, servicing increasingly will become concentrated in the hands of a few "megaplayers." Clearly, some very large servicers are emerging. But it is doubtful that they will become so efficient as to make the business uneconomic for others.

It is important, however, for each mortgage banker to understand and come to terms with the amount of continuing investment that will be required to stay competitive in terms of servicing costs, particularly as cash flow demands cause more churning of servicing portfolios. Each competitor must determine whether it is in the production or servicing business, or both. The skills to manage both businesses are significantly different, with a marketplace now much less tolerant of mediocre management in either business.

Finally, to prosper in the new marketplace, production costs must come down substantially. But how? Retail branch production will continue to be the primary distribution channel. It is not something most firms can abandon. Solutions must be found to reduce branch costs permanently.

Increased average-branch size is clearly one answer. There are pronounced scale economies in retail branches. According to the latest survey by ICM Consultants, Bala Cynwd, Pennsylvania, direct unit cost (in basis points) of mortgage originations fall dramatically as branch size increases.

The unit production costs dropped from 200+ basis points for branches under $25 million in production volume to almost 100 basis points for branches over $125 million in volume, according to the survey.

Cost-effective production translates into the challenge of winning a major share of any market in which the company competes, not a small share of numerous markets.

But size alone is not the answer. Few individual communities will support single branch production of more than $100 million. To realize these scale advantages, which are primarily processing rather than sales-related, a crucial part of retail strategy must be to find ways to concentrate processing without diminishing customer service. That is a tough order, but not impossible.

Branch costs also are not influenced simply by size alone. Size alone does not overcome poor productivity management. The branch is an information factory, one in which information must be processed efficiently and quickly. Very few mortgage banks have yet made much headway in turning their branches into such operations.

The use of technology will help in the battle of scale and efficiency. Yet it cannot be blindly or carelessly applied. Making major inroads into cutting branch costs means fundamentally redesigning the branch distribution system, with technology as the catalyst allowing this to happen.

A critical question in making the future a place where we cash in on opportunities is this one: How do we kill the paper?

Mortgage banking is among the most egregiously paper-laden businesses ever created. We are on the verge of becoming overwhelmed by the paper deemed necessary to produce quality loans. Or are we? We are actually in an information management business—gathering, processing and disseminating information. The technology now exists to eliminate most of the paper we create. How well we address this issue over the coming years will play a central role in keeping individual firms competitive, as the required level of sophistication—that is, the cost of entry into the game—escalates.

On the issue of quality versus cost, experts tell us we do not face a tradeoff between quality of production and cost. They maintain that, in fact, quality and cost go hand-in-hand. Conceptually, this is correct. Firms noted for high quality performance also tend to be lower cost firms. However, we cannot continue to add complexity to our production process where it is not needed. Consumers will reject our demands and go to competitors who have simpler loan application processes. We must individually, and as an industry, better address the balance between reasonable assurance of the quality of the assets being generated and the cost of producing this level of assurance. It cannot remain a relatively one-sided issue.

Speed is increasingly becoming an important solution to several key survival issues.

Finally, speed is increasingly becoming an important solution to several key survival issues: production differentiation; processing costs; and pipeline exposure and risk.

The winners will manage very aggressively the time it takes to approve the typical loan application. Speed is, and will grow in importance as, a competitive weapon. This will require, in many cases, fundamentally changing attitudes in individual companies—shaking up complacency regarding the time it takes to accomplish individual production tasks and eliminating excuses as to why things can't be done more quickly.

Even though we don't control others that must supply us with information in the production process, we can manage much more effectively the timeliness of information we receive from others. Speed may, in fact, become the best attack weapon we possess against competition, cost and risk.

The successful solutions for each company may vary, but the specific challenges they face are essentially the same. There are five common challenges we must all address:

Develop a clear conceptual perspective—No simplistic solutions are likely to be adequate. We are not facing normal industry cyclical changes, but fundamental changes in the way our business is conducted. Each management must have a clear conceptual understanding of what is happening and why, before developing effective responses.

Proper strategic positioning—Each firm must select a specific strategy that is correct for its resources and competitive environment. Unrealistic strategies from either a competitive or internal resource perspective will lead to failure. The margin for error that existed historically is no longer present.

Commitment to change—It's easy to talk about and plan change, but it's painful to develop and maintain a commitment to change. This is particularly so when it involves, as it inevitably must, difficult people and culture decisions. Good planning will accomplish little if the intestinal fortitude to execute the plan is not present.

Intensive effort—This is not business as usual. It will take extraordinary energy both to implement a new order of things while managing effectively the current business. Without properly channeled intensity, it will not get done.

Supplementing the management teams—Reconstituting the management team to supplement it with additional talents is a difficult task, requiring tremendous executive courage. But the changes we face require perspectives and expertise not present in the typical mortgage bank. They must be imported and assimilated effectively to make a difference.

The world our industry faces is not hospitable. There are, to be sure, very significant threats to the survival of each of our firms. But just as certainly, there are substantial opportunities for those competitors that seize them. Mastering the changes required can lead not only to survival but prosperity. Continuing to manage the business as usual will almost certainly lead to extinction. **MB**

Fred Portner is executive vice president of Directors Mortgage Loan Corporation, Riverside, California.

THE TRENDS AND OUTLOOK FOR FORECLOSURE & DELINQUENCIES

Problem loan rates are now nearly double what they were in the late 1960s.

Thomas M. Holloway and Robert M. Rosenblatt

Servicing residential loans is the bread and butter of the mortgage banking business. When loans become delinquent, servicing income is undermined. When they go into foreclosure, servicing value is lost. Consequently, the outlook for delinquency and foreclosure rates is of critical importance to mortgage bankers.

During the 1980s and now in early 1990, there has been cause for concern. Problem loan rates are considerably higher now than they were in the 1960s or 1970s. Although the performance of many categories of problem loans appears to have shown some improvement in the past few years, only modest improvement has occurred in the most severe categories, that is, loans 90 days or more delinquent or in foreclosure.

This article analyzes trends in delinquency and foreclosure rates, examines the causes of defaults and discusses the outlook for problem loans.[1]

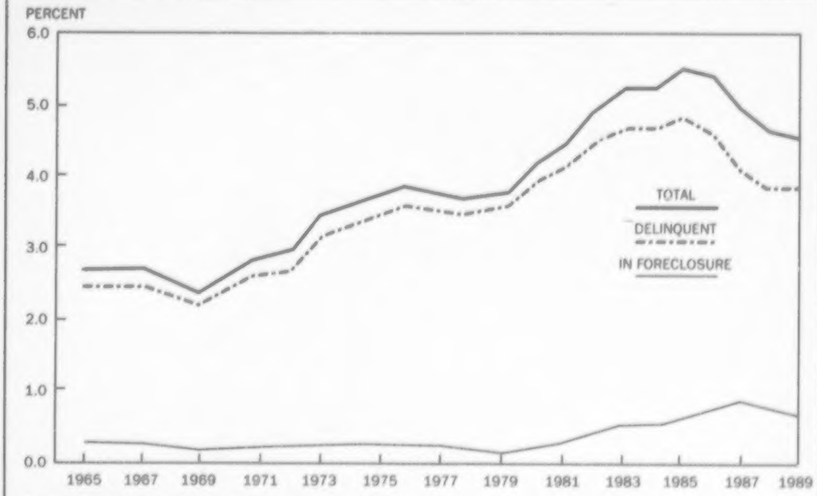
Some of the key findings and most important conclusions include:

- Problem loan rates (delinquencies and foreclosures) rose steadily from the mid-1960s to 1985, before declining in the past few years. Still, problem loan rates currently are nearly double what they were in the late 1960s.
- From 1965 to 1989, the number of delinquent loans rose 265 percent and the number of loans in foreclosure increased 590 percent.
- FHA problem loan rates have been consistently higher than conventional or VA problem loan rates.
- During much of the mid-1960s to 1989, problem loan rates were highest in the Northeast, but problems soared in the South during the 1980s.
- The collapse of energy prices resulted in a sharp increase in problem loan rates in energy states, but was not sufficient to account for the general rise in problem loan rates in the U.S.
- Higher problem loan rates on ARMs during some years in the 1980s and their growing share of total loans outstanding drove up the national problem loan rate in some years, but was not sufficient to account for the general rise in U.S. problem loan rates.
- Changes in 60-day and 90-day delinquency rates provide useful guides to future changes in the percentage of loans in foreclosure.
- The amount of home equity is a crit-

ILLUSTRATION BY JOHN HEINLY

CHART 1

Problem Loan Rates
(Percent of Loans Serviced)



Source: Mortgage Bankers Association

- ical determinant of default rates—this was underscored by statistical tests done for this article. Because home price appreciation is one of the most important determinants of equity, it plays a key role in explaining trends in default rates.
- Changes in the unemployment rate, consumer debt burdens, loan-to-value ratios, and, perhaps, divorce rates also help explain trends in problem loan rates.
- Personal bankruptcies are significantly contributing to the costs of loan problems.
- Problem loan rates are not likely to continue to fall in the early 1990s, but they are not likely to reverse course and rise either. Rather, they are expected to remain roughly at current levels.

National trends

During the late 1960s, the problem loan rate—delinquent loans and loans in foreclosure as a percentage of total loans serviced—stood at about 2 1/2 percent (See Table 1 and Chart 1)[2]. Sharp increases during the first half of the 1970s moved the rate up to around 3 3/4 percent, where it remained during the latter half of the 1970s. Further sharp increases in the first half of the 1980s pushed the rate to about 5 1/2 percent in 1985 and 1986, before it fell to a little more than 4 1/2 percent by 1989. Even with the recent declines, however, the problem loan rate still is almost double what it was in the late 1960s.

Delinquencies comprised the bulk of problem loans throughout this period. The delinquency rate drifted up through the 1970s and early 1980s, peaked in 1985, then declined. To a large extent, this pattern reflected movements in 30-day delinquencies, which rose during most of the period, peaked in 1985, then declined sharply. Unfortunately, the most severe delinquency category—loans 90 days or more delinquent—did not fare as well. In the late 1960s, the rate was about 0.2 percent; by 1985, it had reached 0.8 percent—a fourfold increase. It was still relatively high in 1989 at 0.6 percent.

Foreclosure problems did not improve much either. In the late 1960s, only about 0.2 percent of loans serviced were in foreclosure. By 1987, the rate more than quadrupled to 0.9 percent, and was still 0.7 percent in 1989.

The upshot is that most of the improvement in the problem loan rate in recent years came in the least severe category of delinquencies—loans only 30 days delinquent. Significant problems remain with longer term delinquencies and loans in foreclosure.

The upward trend in delinquency and foreclosure rates coupled with the steady rise in the number of loans serviced caused a dramatic increase in the total number of problem loans. In 1965, about 465,000 loans were delinquent and another 45,000 were in foreclosure. By 1989, about 1.7 million loans were delinquent and another 300,000 were in foreclosure—increases of roughly 265 percent and 590 percent, respectively.

Trends in loan problems among conventional, Veterans Administration (VA), and Federal Housing Administration (FHA) loans were similar, but not identical. Conventional loans, which constituted about 75 percent of loans serviced in 1989, had lower problem loan rates throughout the period. Further, their improvement since peaking at 4.6 percent in 1985 has been greater than the improvement in either VA or FHA loans. Still, conventional loans, like their government guaranteed or insured counterparts, had significantly higher problem loan rates in 1989 than in the late 1960s. The conventional rate was about 1 3/4 to 2 percent in the late 1960s, but was about 3 1/2 percent in 1989. Much of the increase was due to rising delinquency rates, but loans in foreclosure also shot up from 0.1 percent to 0.5 percent by 1989.

The FHA problem loan rate in 1989 was more than twice the rate of the late 1960s despite some improvement since 1985. Throughout the period, the FHA problem loan rate exceeded the rates of VA and conventional loans, sometimes by very wide margins. This outcome is not surprising, however, because the FHA program is designed to serve a portion of the low and moderate income market that the private sector often will not serve as well as borrowers that may be ineligible for VA programs.

The improvement in the FHA problem loan rate since 1985 was primarily due to a sharp improvement in delinquency rates. In 1989, loans in foreclosure remained high, with about 1 1/4 percent of FHA loans outstanding in foreclosure.

Problem VA loan rates did not deteriorate as much as FHA rates from the late 1960s, but they did not improve as much since 1985 either. The VA problem loan rate remained at about 7 1/2 percent from 1985 to 1989. The delinquency rate peaked in 1985, then came down, but the rate of loans in foreclosure continued to rise through 1988, before declining very modestly in 1989. Like FHA loans, nearly 1 1/4 per-

CHART 2

Conventional Problem Loans, 1980
(Percent 90+ Days Del. or in Foreclose.)

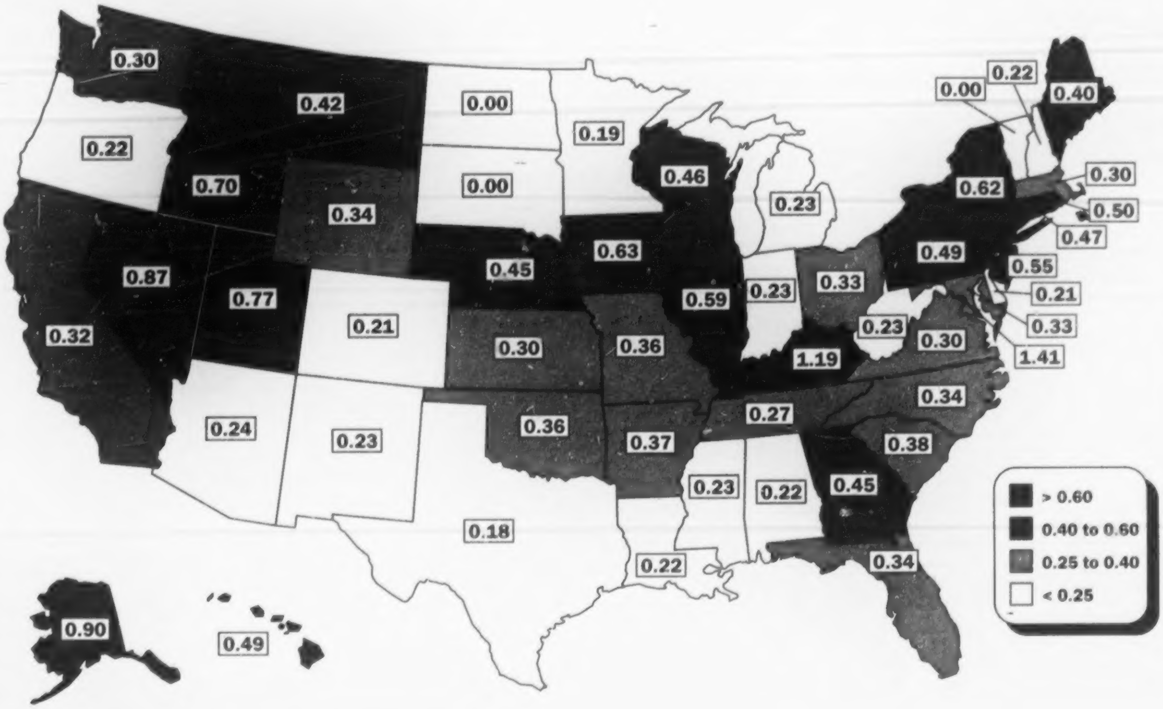

0.30
0.42
0.00
0.19
0.00
0.22
0.40
0.22
0.70
0.34
0.00
0.46
0.23
0.62
0.30
0.50
0.47
0.87
0.77
0.45
0.63
0.59
0.23
0.33
0.49
0.55
0.21
0.32
0.21
0.30
0.36
0.23
0.30
0.33
1.19
1.41
0.34
0.24
0.23
0.36
0.37
0.27
0.38
0.23
0.22
0.45
0.18
0.22
0.34
0.90
0.49
> 0.60
0.40 to 0.60
0.25 to 0.40
< 0.25

CHART 3

Conventional Problem Loans, 1988
(Percent 90+ Days Del. or in Foreclose.)

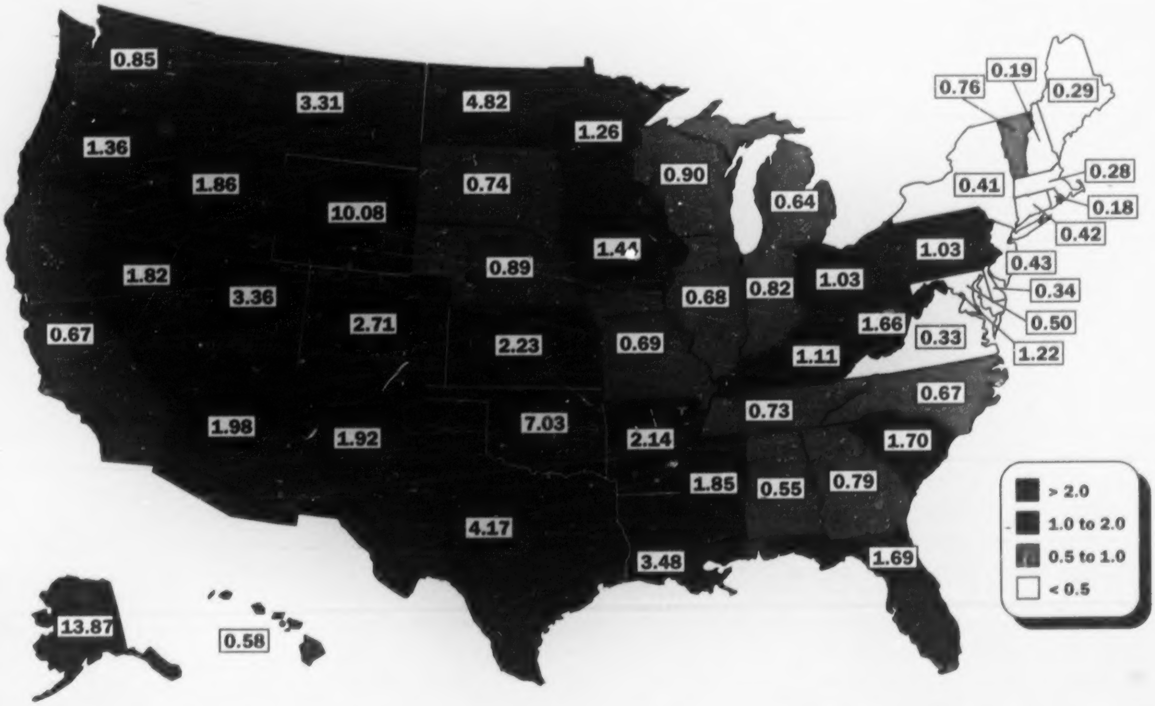

0.85
3.31
4.82
0.76
0.19
0.29
1.36
1.26
1.86
0.74
0.90
0.28
10.08
0.41
0.64
0.18
0.42
1.44
1.03
1.82
0.89
1.03
0.43
3.36
0.68
0.82
0.34
0.67
2.71
1.66
0.50
2.23
0.69
0.33
1.11
1.22
0.73
0.67
1.98
1.92
7.03
2.14
1.70
1.85
0.55
0.79
4.17
3.48
1.69
13.87
0.58
> 2.0
1.0 to 2.0
0.5 to 1.0
< 0.5

TABLE 1

Problem Loan Rates
[Percent of Loans Serviced]

		Delinquent Loans				
	Total	Total	30 Days	60 Days	90 Days or More	Loans in Foreclosure
1965	2.7	2.4	1.8	0.4	0.3	0.2
1966	2.7	2.5	1.8	0.4	0.3	0.2
1967	2.7	2.5	1.8	0.4	0.2	0.2
1968	2.5	2.4	1.8	0.4	0.2	0.2
1969	2.4	2.2	1.7	0.4	0.2	0.2
1970	2.6	2.4	1.7	0.4	0.2	0.2
1971	2.9	2.7	1.9	0.4	0.3	0.2
1972	3.0	2.7	2.0	0.5	0.3	0.3
1973	3.5	3.2	2.3	0.5	0.3	0.3
1974	3.6	3.3	2.4	0.6	0.3	0.3
1975	3.8	3.5	2.5	0.6	0.4	0.3
1976	3.9	3.6	2.6	0.6	0.4	0.3
1977	3.8	3.5	2.5	0.6	0.4	0.3
1978	3.7	3.5	2.5	0.6	0.4	0.2
1979	3.8	3.6	2.7	0.6	0.4	0.2
1980	4.2	3.9	2.9	0.7	0.4	0.2
1981	4.5	4.2	3.0	0.7	0.5	0.3
1982	5.0	4.5	3.1	0.8	0.6	0.4
1983	5.3	4.7	3.2	0.8	0.7	0.6
1984	5.3	4.7	3.2	0.8	0.7	0.6
1985	5.5	4.9	3.3	0.8	0.8	0.7
1986	5.4	4.6	3.1	0.8	0.8	0.8
1987	5.0	4.1	2.7	0.6	0.8	0.9
1988	4.7	3.9	2.6	0.6	0.7	0.8
1989 (p)	4.6	3.9	2.7	0.6	0.6	0.7

Source: Mortgage Bankers Association
(p) = Preliminary.

cent of VA loans outstanding were in foreclosure in 1989.

For mortgage bankers, the problem is especially acute with respect to VA loans due to the "no-bid" situation. VA no-bids arise when VA opts to pay the guaranty—a maximum of $36,000 currently—rather than take possession of the property and pay off the full amount of the loan. VA takes such an action when it would lose less by doing so than by taking possession and selling the property. When a no-bid occurs, the servicer takes possession of the property and invariably loses money on the subsequent sale.

With about 2¼ percent of VA loans 90 days or more delinquent or in foreclosure, many additional claims are likely to arise. Increasingly during the 1980s, VA chose to respond to claims with a no-bid. Because mortgage loan servicers lose substantial amounts of money on virtually every no-bid, improvement in the performance of VA loans could significantly improve the profitability of these servicers. However, few signs of improvement in VA loan performance have emerged at present.

Problem loan rates are considerably higher now than they were in the 1960s or 1970s.

Regional trends

Patterns of change in regional delinquency and foreclosure rates and the levels of those rates underscore pronounced differences in the components that shape the national averages.

During most of the 1965-1989 period, the Northeast had the highest problem loan rates for all loan types. The region's problem loan rates peaked in 1983. The first quarter of 1983 was very near the November 1982 trough of the 1981-82 recession—then trended downward before turning up in mid-1988.

The improvement in Northeast problem loan rates following the recession until mid-1988 generally tracked patterns of economic growth in the region. Robust growth in the Northeast during the 1980s surprised many observers who expected the region's economic sluggishness during the 1970s to continue into the 1980s. Instead, the near boom conditions following the 1981-82 recession drove unemployment rates to below 4.0 percent in seven of the region's nine states, before growth slowed significantly in 1988. This slowdown is probably the primary cause for the upturn in problem loan rates in the region since mid-1988.

Problem loan rates for all loan types in the Midwest and West trended upward during most of the period. VA and FHA problem loan rates peaked in 1985 in both regions, and conventional loan rates peaked in 1983 in the West and in 1986 in the Midwest. Even after substantial improvement, these regions' conventional problem loan rates in early 1989 were still 70 to 80 percent higher than during the late 1960s. The problem loan rates of VA and FHA loans ranged from 80 to 160 percent higher.

The extent of improvement in the two regions since 1985 differed by loan type. The improvement in rates for conventional loans was about the same in the two regions, but improvement in rates for government guaranteed or insured loans was slightly better in the Midwest than in the West. One possible explanation is that home prices reached levels in some markets in the West—notably in California—where homes in the middle price range locally required loans beyond the FHA loan limits or the secondary market ceiling for VA loans. If default rates on mid-range homes are relatively favorable (low), as some evidence suggests, then the more modest improvement in problem loan rates in the West may have reflected the failure of government loan limits to keep pace with home prices.

In some ways, the situation in the South is the most troubling of the four regions. Like the other regions, problem loan rates climbed during most of the period, but, atypically, problem loan rates for VA and FHA loans in the South did not turn downward after 1985 or 1986. Further, although conventional problem loan rates in the South declined slightly after 1986, the rate remained the highest conventional problem loan rate of all of the regions in 1989, after having been the lowest as recently as 1984.

The severity of problems with VA and FHA loans in the South was exemplified by the surge in foreclosures. The percentage of both VA and FHA loans in foreclosure jumped 0.9 percentage points there from 1983 to 1989, nearly double that of the next largest increase of any other region. In short, loan performance in the South deteriorated more significantly than anywhere else during the 1980s.

Part of the South's problems, of course, stemmed from movements in energy prices. These prices began a slow decline starting around the end of the 1981-82 recession, then collapsed in 1986. This weakness in prices undercut business activity and employment in extraction industries and contributed to major economic downturns in several Southern states, notably Texas, Louisiana and Oklahoma. Because of Texas' size, the South felt the energy price collapse particularly hard; but it was not alone in absorbing the aftershocks.

Charts 2 and 3 show the sum of the conventional 90-day or more delinquency rates and the percentage of conventional loans in foreclosure by state for 1980 and 1988, respectively. The charts illustrate two important points. First, a comparison of the rates in 1980 with those in 1988 dramatically shows the extremely large relative increases in problem loan rates in energy states, such as Texas, Oklahoma, Louisiana, Colorado, Alaska, West Virginia and Wyoming, compared to most other states. Second, however, is that problem loan rates rose in many states not tied to energy production in any important way. In short, weaknesses in energy-producing states contributed to the rise in national problem loan rates, but did not account for most of the deterioration.

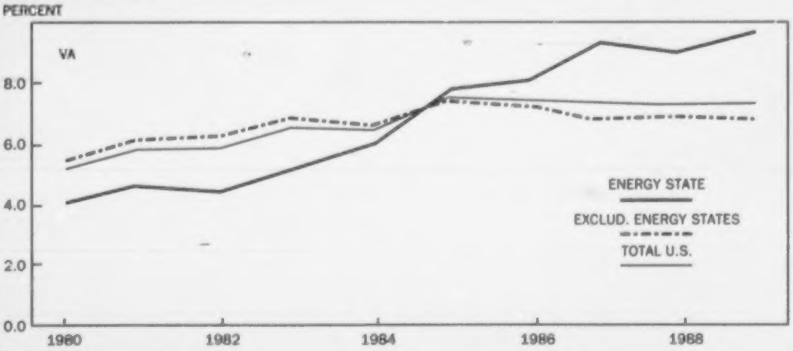
TABLE 2

Changes in Problem Loan Rates in the 1980s in Energy States and Excluding Energy States
(Percentage Points)

	Change in Problem Loan Rates from 1980 to 1985			Change in Problem Loan Rates from 1985 to 1989		
Loan Type	**U.S. Total**	**Energy States**	**Excluding Energy States**	**U.S. Total**	**Energy States**	**Excluding Energy States**
Conventional	1.5	3.9	1.1	−1.2	1.5	−1.5
VA	2.4	3.7	2.1	−0.2	1.9	−0.6
FHA	2.3	3.4	2.1	−1.0	1.0	−1.4

CHART 4

Problem Loan Rates by Loan Type in Energy States and Excluding Energy States
(Percent of Loans Serviced)



Note: Rates are for the first quarter.

The energy states consist of the 10 states with the largest shares of their total employment in 1985 in extraction industries. These include: Texas, Alaska, Colorado, Oklahoma, Louisiana, Wyoming, New Mexico, Kentucky, West Virginia and North Dakota.

TABLE 3

Variables Commonly Tested in Determining the Probability of Default and Their Expected Relationship with Default Rates

Variables	Expected Relationship with Default Rates[1]
Borrower Characteristics:	
Poor credit history	Positive
Investor rather than owner occupent	Positive
Number of years at current job	Inverse
Income growth	Inverse
Family size	Positive
Self-employed and/or commission income rather than salaried	Positive
Unemployed	Positive
Recent divorce	Positive
Income from child support or alimony	Positive
Debt-to-income ratio	Positive
Loan Characteristics:	
Loan-to-value ratio	Positive (especially if greater than 90 percent)
Loan type	FHA and VA higher than conventional Graduated payment higher than level payment Adjustable rate higher than fixed-rate
Loan age	Maximum loan problems tend to occur 3-5 years after origination
"Cash out" refinancing rather than rate reduction refinancing	Positive
Negative amortization	Positive
Contract rate below market rate	Ambiguous; borrowers try to avoid default to retain a below market interest rate; portfolio lenders may try to press foreclosure to reinvest funds at higher current rates
Property Characteristics:	
Price appreciation	Inverse
Condominium rather than single-family detached	Positive
Institutional Characteristics:	
Judicial foreclosure procedure rather than power-of-sale	Inverse
Length of statutory period of redemption	Inverse
Presence of deficiency judgments	Ambiguous; default can be more costly to borrowers in deficiency judgment states, providing borrowers with a strong motive to avoid foreclosure; lenders may press foreclosure in deficiency judgment states because they may have further recourse

1. "Positive" indicates that default rates and the variable in question tend to rise together; "inverse" indicates that default rates and the variable tend to move in opposite directions.

Carving out the energy states results does not fundamentally alter the national pattern of problem loan rates in the 1980s. Chart 4 illustrates the point using VA loans as an example. Further, Table 2 shows changes in problem loan rates in the energy states, in the non-energy states and for the U.S. as a whole from 1980 to 1985 (the latter year is approximately the peak of problem loan rates) and from 1985 to 1989. As Table 2 and Chart 4 clearly illustrate, excluding the energy states produces series that still track national problem loan rates closely. Consequently, the secular rise in problem loan rates was not caused by specific regional problems, but by broad-based national influences. A review of some recent research is a helpful way to identify some of these influences.

Results from previous studies on delinquency and foreclosure

Table 3 summarizes some of the common variables considered in delinquency and foreclosure research and the expected relationships with default rates. The table does not distinguish explicitly between delinquency and foreclosure. Some researchers have emphasized that the same factors that affect delinquency rates may not affect foreclosure rates. The opposite also holds true. While both points of view have merit, underwriters and loan administrators must focus on all factors and relationships associated with loan problems during the life of the loan. Virtually all loans are delinquent for a substantial period of time before a foreclosure proceeding is initiated. During that time, the cumulative interest in arrears may offset any equity the borrower has in the property, making it a potentially rational choice for the borrower to allow the property to go into foreclosure even if the property value exceeds the loan amount by a substantial margin.

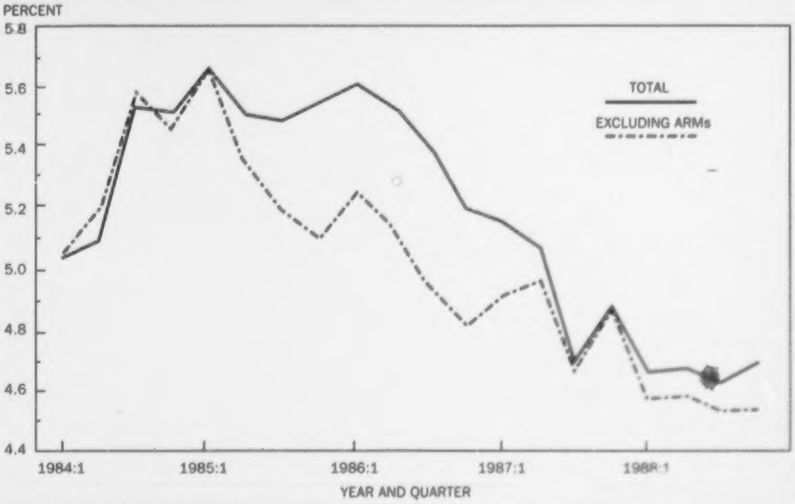
A common point of departure among theoretical models used for studying defaults is that the amount of equity is crucial. One typical theoretical model is set up to view mortgage default as a put option, giving the borrower the right to sell the house to the lender for the principal balance. Wealth-maximizing borrowers will be increasingly likely to exercise this option whenever the market value of the house, net of all relevant transactions costs (e.g., selling costs, moving expenses, etc.), is less than the market value of the mortgage.

The increasing importance of adjustable rate mortgages (ARMs) also has been viewed by some as a fundamental cause for the sharp rise in default rates from the 1970s to the 1980s.

An analysis of the basic components of net equity (derived using the market rather than the par value of mortgages) suggests that initial loan-to-value ratios, home price appreciation rates, current versus contract mortgage interest rates and the age of loans should all influence default rates. The lead-lag relationships, however, between these variables and default rates are complex. For example, frequently there's a long lag from the time the fundamental conditions leading to default occur, and the time the loan goes into foreclosure. Also, some research suggests that current, negative net equity may not trigger a default if borrowers expect significant equity gains from future appreciation. In short, borrowers are concerned with maximizing their long-term wealth position, not just their wealth at any point in time. Consequently, borrowers' expectations play a key role in the outcome of a problem loan.

CHART 5

Problem Loan Rates Including and Excluding Adjustable Rate Mortgages
(Percent of Loans Serviced)



Source: Mortgage Bankers Association

Defaults are most common three to five years after origination, or perhaps a bit earlier for FHA loans. This lag relationship suggests that developments during the first few years of the loan contribute to defaults and have an important impact on the loan's future.

Aside from net equity, studies have tested the effects that the following have on default rates: age, sex, occupation, payment burden (typically measured as mortgage payment-to-income ratios, with variants including inflation adjusted and nominal measures, pre- and after-tax measures and assorted combinations), marital status, number of dependents, source of income (e.g., wage and salary, commission, child support, alimony, etc.), unemployment rates and other borrower characteristics. Many of these variables are viewed as proxies for the reliability of income streams over time. In some studies, they are found to be important influences, but in others, they're not significant.

The increasing importance of adjustable rate mortgages (ARMs) also has been viewed by some as a fundamental cause for the sharp rise in default rates from the 1970s to the 1980s. The rationale behind this view is that payment shock results in defaults as income growth falls behind payment adjustments. This would be more credible in an environment of continuously increasing interest rates. However, interest rates fell during most years from 1981 to 1985—a period when problem loan rates were rising. Further, FHA and VA problem loan rates rose sharply even though no VA loans are ARMs and only a handful of FHA loans are ARMs.

Still, ARMs appear to have greater delinquency and foreclosure problems than fixed-rate loans during some periods. These problems are magnified by the sharp rise in the ARM share of loans outstanding, from a very small share in the late 1970s, to about 10 percent in 1984, to roughly 26 percent by the end of 1988. Chart 5 shows the total problem loan rate quarterly from the first quarter of 1984 to the final quarter of 1988. It also shows the problem loan rate excluding ARMs. Both measures declined sharply between 1985 and 1988, but it is clear that ARMs kept the total problem loan rate much higher during late 1985 and early 1986 than it would have been without them. The wide gap between the two measures reflects the relatively more severe loan problems of ARMs. However, the two measures ultimately converged as ARM delinquency and foreclosure rates improved significantly in 1987 and 1988. The bottom line is that ARMs played a role in increasing loan problems during the mid-1980s, but the general patterns of problem loan rates remain even if ARMs are excluded from the mix. Therefore, ARMs alone do not account for the broader trends.

In addition to borrower and loan characteristics, the institutional framework of a state for handling foreclosure proceedings can influence the decision of a lender to foreclose. For example, if the circumstances are the same, the probability of foreclosure is lower in states requiring judicial foreclosures than in states with much less costly power-of-sale foreclosures.

On a quarterly basis, longer term delinquencies are expected to follow the path of shorter term delinquencies with a lag.

The institutional framework also can influence a borrower's decision to default. Deficiency judgments are permitted in most states and allow lenders to recoup losses from the sale of foreclosed properties with negative equity by attaching claims to borrowers' other personal assets. The threat of deficiency judgments in most states almost certainly holds down foreclosure rates. California is the largest state that does not permit deficiency judgments.

The conclusion that emerges from research on defaults is that net equity appears to be the most crucial determinant. Experience shows that if income is inadequate to meet payments, movement toward foreclosure is inevitable. However, most studies are unable to find clear statistical links between payment-income imbalances and foreclosures. Finally, the institutional characteristics of state foreclosure procedures appear to have some influence on the decisions made by borrowers or lenders.

Relationships among problem loan rates

On a quarterly basis, longer term delinquencies are expected to follow the path of shorter term delinquencies with a lag. For example, FHA 60-day delinquencies should reflect movements in FHA 30-day delinquencies in prior months; 90-day delinquencies should reflect movements in 30-day delinquencies with even a longer lag. The logic, of course, is that unremedied delinquent loans move through this sequence of categories to end up in the 90-day or more category and ultimately in foreclosure.

Statistical tests confirm these expected relationships. For all three loan types, changes in 90-day delinquency rates are significant indicators of changes in the percentage of loans in foreclosure, and changes in 60-day delinquencies reliably portend changes in 90-day late loans, but changes in 30-day delinquency rates do not appear to be as reliable an indicator. In some cases, these shorter duration delinquency rates reflect future patterns of longer duration rates, but in other cases they do not. It is likely that there is more meaningless movement in 30-day delinquency rates than in the other rates, because normally reliable borrowers miss a single payment for one reason or another at times, but quickly become current again.

There is a very high correlation among default rates across loan types. Movements in FHA delinquency rates tend to mirror movements in VA delinquency rates. Movements in VA delinquency rates, as well as the percentage of VA loans in foreclosure, tend to mirror movements for both these categories for conventional loans, and so forth.

Statistical tests

Given the findings of previous studies and the statistical relationships among default rates of various durations and across loan types, it is likely that a common set of factors can help to explain the variation in default rates over time. The factors tested here include: changes in home prices, loan-to-value ratios, current versus historical mortgage interest rates, unemployment rates, income growth, divorce rates, consumer debt burdens, changes in interest rates affecting ARM payments and growth in self-employment. The first three factors tested are determinants of net equity; the next six affect income flows and/or reflect the ability to pay.

Changes in home prices—Changes in home prices provide nearly all equity gains after origination until very late into the term of the loan. Early in the life of a loan, very little principal is repaid. Generally, the relationship of home price changes to defaults is inverse. For example, if prices appreciate and equity builds, borrowers will likely make every effort to avoid delinquency problems and are less likely to face foreclosure, because they are more likely to be able to sell their home for more than the amount due on the loan after expenses. Several measures of home price changes were tested, including the National Association of Realtors' (NAR) median price for existing homes sold (both adjusted and unadjusted for inflation) and the Census Bureau's index of constant quality new home prices (again, both adjusted and unadjusted for inflation).

Loan-to-value ratios—The loan-to-value (LTV) ratio determines the initial equity. The expected relationship with default rates is positive; if the LTV ratio is high and the initial equity is thin, the financial stake may not be large enough to compel borrowers to make their loan payments on time.

> **While mortgage lenders cannot control price appreciation, they can partially respond to debt burdens through careful underwriting and/or quality control.**

Current versus historical interest rates—The difference between current and historical interest rates provides a guide to the market versus par value of a loan. The expected relationship is inverse for delinquencies, but ambiguous for foreclosures. If the current market rate is higher than the historical rate, borrowers holding loans at the historical rate are certain to try to avoid loan problems because their payments would rise if they were forced to acquire new loans (if possible at all) at the current rates following a default.

Lenders may have a different response. Lenders have limited influence over delinquencies, but do have choices concerning foreclosures. If the current market rate is greater than the historical rate, portfolio lenders may push forward with foreclosure proceedings. Because borrowers and portfolio lenders may react to the difference between current and historical interest rates in opposite ways, the relationship of this difference to the percentage of loans in foreclosure is ambiguous. Further, it is likely that expectations about changes in the difference are critical because mortgage loans are such long-term instruments. Consequently, it may be that what matters are the changes in the rate differential rather than the disparity itself.

Unemployment rates—The unemployment rate affects income flows. Default rates generally increase with rising unemployment. The variable chosen to represent unemployment is the Bureau of Labor Statistics' (BLS) civilian unemployment rate for 25- to 54-year old males. This unemployment rate provides a better gauge of cyclical movements in the economy over the past 25 years than the overall unemployment rate, because the latter rate is strongly influenced by shifts in the age and sex composition of the labor force.

Income growth—The expected relationship of income growth with default rates is inverse; as the ability to pay increases with income, loan problems are likely to diminish. The income variable is measured by changes in the Bureau of Economic Analysis' (BEA) real disposable personal income per capita.

Divorce rates—Divorces can affect both the ability to pay and the willingness to pay. The expected relationship with default rates is positive; as couples divorce, income that previously supported one household must now often support two. Further, in hotly contested divorces, disputes over property and financial responsibilities can result in the failure to make mortgage payments by either party.

Consumer debt—Consumer debt burdens can restrict a borrower's ability to pay. The expected relationship with default rates is positive. As consumer debt (excluding mortgage debt) rises relative to income, borrowers may be unable to meet all their financial obligations, including their mortgage payments. The variable is measured as the ratio of the Federal Reserve's consumer installment debt outstanding to BEA's personal income.

ARM rate changes—Changes in interest rates affecting ARM payments impact the ability to pay. The expected relationship with default rates is positive; as ARMs are adjusted upward, loan problems may rise. The variable is measured as the change from one year ago in the one-year constant maturity Treasury rate—the most common index used to adjust ARM rates. The variable enters the analysis only in the 1980s as ARMs grew in volume.

Self-employment growth—The growth in self-employment affects the stability of income flows. Self-employment income tends to be much more volatile than the generally stable flow from wage and salary employment. Therefore, the relationship with default rates is expected to be positive; as self-employment increases as a percentage of total employment, loan problems may rise. The variable is measured as the ratio of nonagricultural self-employed workers to all nonagricultural workers (BLS household survey).

Obviously, all of the measures of the variables as discussed are proxies. Further, practically all of these measures have statistical problems of their own limiting their reliability in measuring what they purport to measure. Even so, the results of the tests are quite interesting.

Results

Separate tests were done on conventional delinquencies of 60 days or more and on the percentage of conventional loans in foreclosure. Tests were also done on comparable measures for VA and FHA loans, resulting in a total of six separate tests. In all cases, the factors tested (taken together) explained virtually all the variation in the respective default rates by loan type.

Across all tests, the unemployment rate, prices and consumer debt appear to be among the most important factors tied to higher default rates. The unemployment rate showed the expected relationship and was statistically significant in explaining default rates in four of the six tests; while price increases showed the expected relationship and were statistically significant in all six tests. (Here, the NAR nominal median price measure performed best among the measures of price change.) Finally, the consumer debt variable had the expected relationship with defaults and was highly significant in five of the six tests.

The LTV and ARM variables were tested for conventional loans only. The LTV variable demonstrated the expected relationship with defaults and was highly significant in the conventional delinquency and foreclosure tests. The ARM variable demonstrated the anticipated connection with problem loan rates and was statistically significant in the delinquency test, but not in the foreclosure test.

The remaining variables—income, divorce rates, self-employment, and current versus historical mortgage rates—showed mixed results, but did not appear to be as important as the variables already discussed. The divorce variable showed the expected relationship and was highly significant in the VA and FHA delinquency tests, but was not significant in any of the other tests. Similarly, the self-employment and current versus historical interest rate variables appeared to influence conventional delinquency rates in the anticipated ways, but did not appear to matter much in the other tests. The income variable was not significant in any of the tests.

Although obviously not conclusive, the tests do produce some interesting results consistent with prior research and common sense. Trends in unemployment, home prices, loan-to-value ratios and consumer debt appear to be very significant contributors to the secular rise in default rates.

The possibility of a recession sometime within the next several years, which can't be ruled out, would almost certainly result in a temporary rise in default rates.

Institutional factors

These tests do not capture some institutional developments that also may have contributed to rising problem loan rates. The first has been discussed briefly: the effects of state foreclosure laws. Another is personal bankruptcy.

It has been suggested that state foreclosure laws influence the willingness of lenders to pursue foreclosure aggressively. If the process is extremely time-consuming, it may be more profitable for lenders to make financial concessions in order to resolve the deficiency rather than pursuing foreclosure. Because shifts in the nation's population with time contribute to a gradual shift in the geographical distribution of the housing stock and related mortgages, the national foreclosure rate could rise solely due to increased housing market activity in states with laws more conducive to foreclosure. Indeed, some of the fastest growing states during the 1970s and the 1980s, such as California, Texas and Florida, are also states that process foreclosures in shorter periods than the national average. As the share of loans increases in such states, the national foreclosure rate may drift up as a consequence.

To examine this possibility, a variable was created that measures the effects of shifts in housing market activity among states on the national average number of weeks required to complete foreclosure. Tests indicate that the expected inverse relationship with default rates was confirmed for all three loan types; as the length of time increases, some lenders may attempt to avoid the foreclosure process as much as possible. Consequently, the shift in the nation's population toward states with foreclosure laws that are simpler and less costly for lenders may have contributed to the secular rise in the percentage of loans in foreclosure. However, this conclusion is somewhat speculative.

Another institutional factor that may influence default rates is personal bankruptcy. A bankruptcy filing temporarily halts collection efforts by creditors; therefore, mortgage defaults may rise as bankruptcies rise. Unfortunately, testing the impact of personal bankruptcies on mortgage default rates is difficult. Research by the Administrative Office of the U.S. Courts—the organization that compiles data on bankruptcy filings—suggests that the consumer debt-to-income ratio is a critical determinant of bankruptcies. However, because a similar variable is probably an important cause of mortgage defaults, it is difficult to prove that bankruptcies per se contributed to the rise in mortgage default rates.

The significant liberalization of bankruptcy laws during the late 1970s made it easier to declare bankruptcy. As a result of that liberalization, the stigma attached to bankruptcy greatly diminished during the 1980s. These changing attitudes and increasing willingness to use bankruptcy made it likely that mortgage problems could increase as a result.

There is no doubt that bankruptcy filings are on the rise. In 1978, there were about 175,000 personal bankruptcies filed in the United States, or about 0.08 per capita; by 1988, there were about 750,000 filed, or about 0.30 per capita—nearly a four-fold increase per capita.

Outlook for delinquency and foreclosure problems

The decline in the delinquency rate since 1985 may have reached a trough in the short-run. The total delinquency rate for all three loan types was slightly higher in 1989 than in 1988. On the other hand, the earlier declines in delinquency rates are still contributing to declines in the percentage of loans in foreclosure. For all of 1989, the percentage dropped about 5 to 10 basis points from 1988 for conventional and VA loans and an impressive 20 basis points for FHA loans.

However, with delinquency rates showing few signs of decreasing further in the short run, the prospects for further declines in the percentage of loans in foreclosure are limited. It is more likely that the percentage will stabilize around current levels.

Over the long-run, the outlook for default rates hinges on the fundamental contributing factors discussed earlier. The most important ones likely include changes in home prices, consumer debt burdens, LTV ratios, the impacts of institutional factors, trends in unemployment rates, and, perhaps, changes in divorce rates. The direction each will take, in turn, is far from certain.

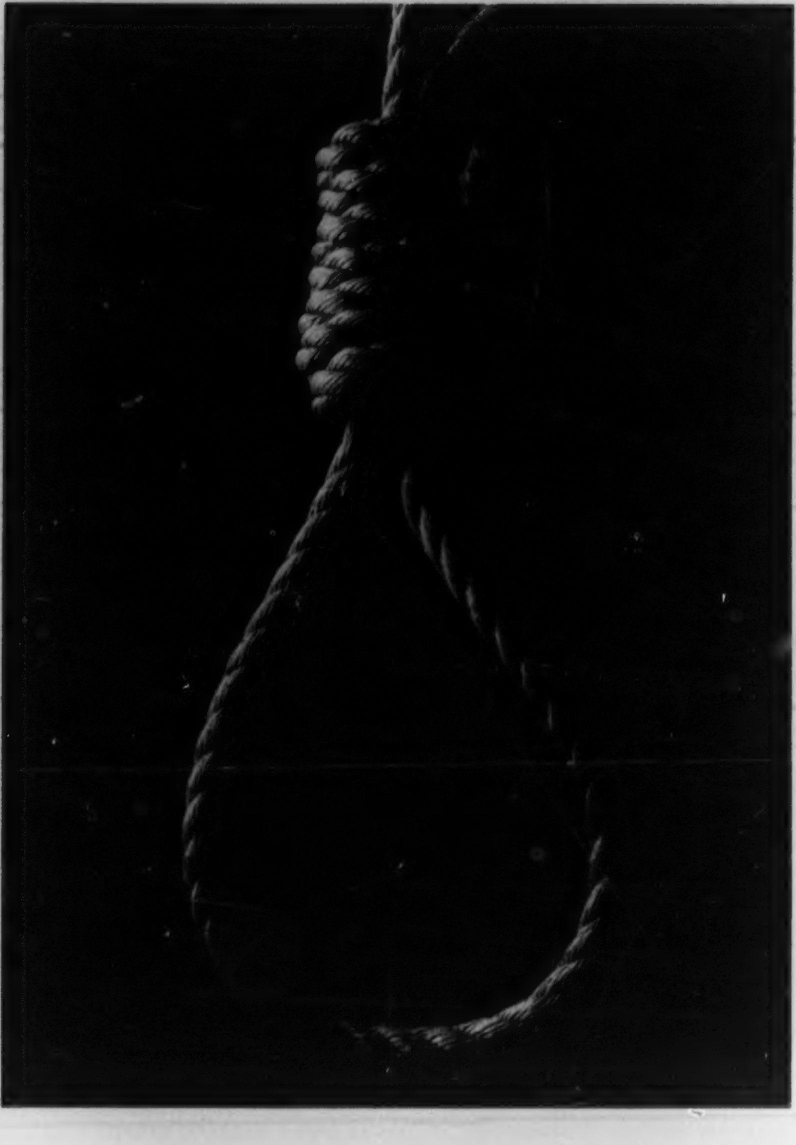
Nominal home prices are likely to increase at a more modest rate over the next decade than during the late 1970s and some of the 1980s. Price appreciation in these latter periods was strongly influenced by the explosive increase in household formations, coupled with extraordinarily low real after-tax mortgage interest rates. The demand pressures on prices from demographic changes will be much less pronounced in the 1990s. Further, real after-tax mortgage interest rates are likely to remain relatively high. Reduced demand from these sources—if not offset by other sources of demand or supply pressures—will likely mean slower price appreciation and slower equity accumulation. Because equity growth is critical in holding down default rates, modest price appreciation in the 1990s is not likely to be a strong force in reducing default rates. But equity growth will probably be strong enough to contribute to stability in those rates.

The outlook for consumer debt is less favorable. Consumers continue to amass debt at a rapid rate. Concerns about consumer debt accumulation have been raised many times in the past 50 years, but the economy has not faced the dire consequences often predicted. For lenders, though, there is reason for concern. Large debt burdens coupled with bankruptcy filings are hurting mortgage lenders. These factors are likely to continue to put upward pressure on default rates in the 1990s.

While mortgage lenders cannot control price appreciation, they can partially respond to debt burdens through careful underwriting and/or quality control. Loans very close to maximum ratios could be rejected. This would not prevent some borrowers from increasing their debt burdens sharply after a loan is made, but it would eliminate some high-risk borrowers that show a clear propensity to accumulate debt.

Lenders can also control LTV ratios. This factor will become even more important in the 1990s because price appreciation is likely to be much more modest. Stricter underwriting guidelines and quality control standards can be used to compensate for slower appreciation and to reduce defaults. Of course, reducing risk this way could be costly and involves business decisions. Some risk must be incurred to make a profit.

The outlook for the unemployment rate is for a modest increase in the next year or so, as the economy grows below its potential growth



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rate. Over the longer term, however, the outlook is much better than 15 years ago. The surge in new workers from the baby boom generation is over. As the economy continues to grow in the 1990s, a labor shortage is more likely to develop than a labor surplus. This can be mitigated by immigration or other factors, but the outlook for the long-run unemployment rate is favorable.

Finally, the divorce rate appeared to peak in the early 1980s and is now coming down. This trend is likely to continue into the 1990s and should help put downward pressure on default rates.

Taken together, there are obviously many conflicting factors that are likely to play a role in determining default rates in the 1990s. The possibility of a recession sometime within the next several years, which can't be ruled out, would almost certainly result in a temporary rise in default rates. Matters are complicated further by the ongoing resolution of the thrift crisis. Disposition of properties may depress appreciation rates in some areas, thereby increasing the probability of default, or may affect defaults in ways that are difficult to anticipate currently. Still, there are not compelling reasons to believe that default rates will rise sharply in the 1990s. On the other hand, there are not compelling reasons to believe that they will continue to come down either.

Lenders will play a key role. Tighter underwriting standards and quality control guidelines can make a difference. Whether such standards and guidelines justify their added costs may well determine the future course of default rates. **MB**

Thomas M. Holloway is senior economist at the Mortgage Bankers Association of America (MBA). Robert M. Rosenblatt is an economist at MBA.

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[1] See Thomas M. Holloway and Robert M. Rosenblatt, "Problem Loans: Trends, Causes, and Outlook for the Future," economics department, Mortgage Bankers Association of America (MBA), April 1990 (mimeo) for an expanded version of this article with much more technical and statistical detail.

[2] The estimates of "total" problem loans rates shown in Table 1 and Chart 1 and elsewhere in the article differ from estimates for the "all loans" category published in MBA's *National Delinquency Survey* (NDS) because the NDS includes a disproportionate number of mortgage bankers relative to other types of lenders. The estimates here adjust the NDS numbers to better reflect national averages. See the Holloway-Rosenblatt paper cited in footnote 1 for details.

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ECONOMIC TRENDS

The refinancing of mortgage loans is often an important component of total origination volume. For example, a survey of a dozen or so large mortgage banking companies revealed that refinancing volume in recent months accounted for 15 to 20 percent of total application volume. At the peak of refinancing activity in late 1986 and early 1987, nearly half of all origination volume involved refinancings.

An interesting aspect of refinancing is that, in most cases, it involves converting some home equity into cash. In this regard, refinancing is like home equity lines of credit, second mortgages and other methods to convert equity.

Given the obvious importance of refinancing, generally, and as a means to convert home equity into cash, in particular, it is not surprising that a recent article prepared by the Federal Reserve Board (Fed) on the subject makes interesting reading. The article, entitled "Mortgage Refinancing," appears in the August 1990 issue of the *Federal Reserve Bulletin*. The article begins with general comments about why homeowners refinance, then turns to reporting results from a nationwide survey of homeowners who were asked a series of questions about their mortgages.

TABLE 1

Holdings of First Mortgages and Refinancing Activity Among Homeowners, 1989
(Percentages)

	U.S. Total	Regions			
		Northeast	Midwest	South	West
Share of homeowners:					
Without mortgages	46	44	49	49	34
With mortgages	54	56	51	51	66
Share of homeowners with mortgages who:					
Refinanced their mortgages[1]	20	27	20	13	26
Held a home equity loan	15	26	12	11	14

Source: Federal Reserve Board

[1] Share with current mortgages that were refinanced at some time in the past.

TABLE 2

Uses of Equity Converted to Cash[1]
(Percentage of Equity Converters Citing Use)

Use	Home Equity Line of Credit		Traditional Second Mortgage	Refinancing Resulting in Liquidized Equity
	Initial Use	Subsequent Uses		
Home improvement	38	58	45	46
Repayment of other debts	40	28	35	36
Education	11	20	1	3
Auto, truck purchases	7	30	5	5
Medical expenses	3	16	0	2
Other[2]	26	43	27	34

Source: Federal Reserve Board

[1] Uses may sum to more than 100 percent in individual columns due to multiple uses of the same funds.

[2] Includes purchases of furniture, appliances, boats and other durable goods, vacations, real estate investments and business uses.

In reviewing the reasons homeowners refinance, several motives emerge. First, and most important, homeowners refinance to reduce interest costs on their existing loans. As simple and obvious as this motive is, deciding exactly when to refinance and which mortgage instrument to use is complicated. Discounted, after-tax interest savings resulting from refinancing must be enough to offset after-tax closing costs. Because interest savings accrue with time, the length of time the homeowner plans to remain in the home is a key factor. Further, if interest rates are declining as they typically are when refinancing activity picks up, homeowners must decide whether savings gained by waiting for rates to drop further offset savings lost by paying interest at a higher rate while waiting. Finally, homeowners must weigh the advantages and disadvantages of ARMs versus FRMs.

A second major motive to refinance is to cash out equity to use for other purposes, such as financing home improvements, buying consumer goods, paying off other debts and the like.

A third motive is to reduce monthly payments even if interest rates are not lower. This can be accomplished, for example, by refinancing a fully amortizing 30-year FRM with 20 years remaining by a new 30-year FRM at the same interest rate.

The Fed survey tells us a great deal about homeowners and their mortgages. Table 1 summarizes some of the basic findings. To begin with, 46 percent of homeowners nationwide own their homes free and clear. However, there are significant regional differences. In the Midwest and South, 49 percent of homeowners had no mortgage debt; but in the Northeast, it was 44 percent, and in the West, only 34 percent. These latter regions had brisk turnover of existing homes during much of the 1980s, which probably contributed to the relatively large proportion with mortgage debt.

Of homeowners who have mortgage debt, 20 percent had refinanced at the time of the Fed's survey and 15 percent had home equity loans, with some overlap in these two groups. Of those who refinanced, nearly 60 percent cashed out some equity above the amount needed to cover closing costs.

Table 2 shows the major uses of cashed-out equity arranged by the means used to convert the equity. As the table shows, regardless of the means of converting equity, the two single most important uses are for home improvements and the repayment of other debts. For home equity lines of credit, use for education expenses, medical expenses and auto purchases was also common. Changes in tax law in recent years almost certainly spurred the use of home equity lines of credit for these purposes. In the case of refinancings, use of cashed-out equity for these purposes was much less common. A large item in the "other" catego-

Economic Trends *continued on page 135*

VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
	FHA	CONVENTIONAL[2]		Median Cost of Funds	1-Yr.	FRM		
1990	New Homes[1]	FRM	ARM	SAIF Institutions	ARM	Conv.	ARMs	FRMs
MAY	10.49%	10.54%	9.28%	7.58%	8.45%	10.29%	8.59%	10.48%
JUN	10.21	10.57	9.33	NA	8.27	9.98	8.49	10.16
JULY	10.15	NA	NA	NA	8.14	9.88	8.43	10.04
AUG	**NA**	**NA**	**NA**	**NA**	**7.96**	**10.00**	**8.35**	**10.10**

SELECTED SECURITIES

		PRIME COMMERCIAL PAPER	U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	(3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
MAY	8.18%	8.25%	7.76%	8.32%	8.69%	8.76%	10.04%
JUN	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JULY	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG	**8.13**	**7.88**	**7.38**	**7.78**	**8.22**	**8.75**	**10.29**

CURRENT SECONDARY MARKET YIELDS

SPREADS
(Basis Points)

1990	GNMA[3]	FNMA[3]	FHLMC[3]	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
MAY	9.99%	9.93%	9.92%	123	117	116
JUN	9.73	9.73	9.72	125	125	124
JULY	9.66	9.66	9.66	119	119	119
AUG	**9.80**	**9.75**	**9.75**	**105**	**100**	**100**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA*				FHLMC				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments**	Purchases	Out-Standing	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
MAY	$1,960	$1,630	$257,218	$7,081	$5,093	$8,502	$6,064	$5,792	$7,038	$5,197
JUN	2,089	1,802	263,330	8,266	5,549	11,183	5,856	5,546	6,851	5,739
JULY	2,215	2,304	268,052	6,869	4,507	5,851	4,527	4,247	8,553	5,553
AUG	**2,302**	**2,134**	**275,227**	**9,378**	**NA**	**NA**	**NA**	**NA**	**NA**	**NA**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,518	60,149	57,522
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
7 MONTH AVG. 1990	1,905	1,909	---	7,932	5,993	8,005	5,779	5,905	5,457	5,223
1989	2,136	1,584	---	4,676	5,979	6,969	5,595	5,158	4,113	4,337
1988	2,202	2,149	---	4,206	2,826	5,369	3,148	2,702	4,361	4,067

*FNMA year to date averages are for eight months.

**Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
MAY	1,206	933	273	1,065	853	212	127	256	487	336	124	218	410	313
JUN	1,189	931	258	1,108	844	264	113	241	535	300	121	224	428	335
JULY	1,147	808	249	1,082	838	244	110	223	494	320	111	227	428	316
AUG	**1,127**	**872**	**255**	**1,036**	**818**	**218**	**119**	**234**	**441**	**333**	**113**	**224**	**402**	**297**
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	505	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
8 MONTH AVG. (SAAR)														
1990	1,281	995	286	1,208	913	295	141	273	507	361	137	270	453	349
1989	1,416	1,079	337	1,343	999	344	193	268	556	400	188	255	508	392
1988	1,473	1,132	342	1,433	1,057	376	256	266	564	387	246	259	533	395

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
APR	3,330	2,660	9.6	533	363	8.3
MAY	3,300	2,740	9.9	536	359	8.2
JUN	3,330	2,650	9.6	561	353	7.7
JULY	**3,440**	**2,630**	**9.2**	**548**	**349**	**7.8**
1989 TOTAL	3,440	---	---	650	---	---
1988 TOTAL	3,594	---	---	676	---	---
7 MONTH AVG. (SAAR)						
1990	3,389	---	---	565	---	---
1989	3,434	---	---	647	---	---
1988	3,476	---	---	668	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

1990	Total[5]	1–Unit	2+ Units	Nonresidential
APR	$313.8	$109.7	$18.7	$94.7
MAY	306.0	105.8	19.1	93.3
JUN	301.2	101.9	17.1	95.0
JULY	**302.0**	**100.2**	**16.8**	**97.2**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
7 MONTH AVG. (SAAR)				
1990	308.8	108.0	18.0	95.1
1989	312.6	111.0	21.4	95.7
1988	314.9	111.7	21.6	93.8

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit

(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[6]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1990 JAN	$34,012	$9,802	$11,023	$12,578	$247	$3,226	$866	$882	$777	$377	$17,217	$149	$759	$12,928	$3,139
FEB	30,305	9,867	9,964	10,129	27	3,041	682	803	768	551	14,039	202	881	9,469	3,320
MAR	33,747	8,703	12,620	12,014	29	2,765	557	1,120	802	61	18,878	102	893	14,794	2,978
APR	**34,102**	**8,406**	**12,949**	**12,405**	**28**	**1,820**	**154**	**1,154**	**317**	**50**	**16,939**	**421**	**811**	**12,240**	**3,048**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85;307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
4 MONTH AVG. 1990	33,042	9,195	11,639	11,782	83	2,713	565	990	666	260	16,768	219	836	12,358	3,121
1989	26,777	5,325	12,755	8,326	71	2,617	295	1,374	531	173	10,233	86	1,523	6,827	1,662
1988	25,448	6,131	11,994	6,897	101	2,416	243	1,394	385	240	14,306	47	1,921	10,527	1,534

MORTGAGE INSURANCE

(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
APR	149	88	16	45	110	$8,601	65	$4,267	15	$1,157	30	$3,177
MAY	155	93	17	45	112	8,919	65	4,382	15	1,236	32	3,301
JUN	150	90	17	43	113	9,021	64	4,280	16	1,309	33	3,423
JUL	**144**	**84**	**15**	**45**	**119**	**9,666**	**67**	**4,509**	**15**	**1,254**	**37**	**3,903**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	505	1,334	98,012	699	42,577	211	15,771	424	39,664
7 MONTH AVG. 1990	145	88	17	40	113	8,838	66	4,342	17	1,326	30	3,170
1989	137	81	15	41	99	7,464	56	3,485	15	1,167	28	2,812
1988	154	85	17	52	109	7,910	57	3,453	17	1,247	35	3,210

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1] Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2] Effective rate on loans closed.

[3] Securities for 0- to 30-day delivery.

[5] In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[6] In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7] Savings & Loans and Mutual Savings Banks.

[8] FHA applications received includes the Direct Endorsement Program.